INTRODUCTION

The “golden parachute” tax under Internal Revenue Code Sections 280G and 4999 can have a significant, adverse impact on “change in control” payments, penalizing both the employer and the executive. Section 280G denies a corporate tax deduction for, and Section 4999 imposes a nondeductible 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. As the Section 280G “gross-up” has become less common in recent years, due to, among other things, pressure from shareholder advisory firms, corporations and their executives have a common interest in minimizing or eliminating golden parachute tax consequences.

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.

This article is the first installment of a two-part series, and 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. The second installment of the article addresses special 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.

Generally, a Section 280G “parachute payment” is a payment in the nature of compensation that is contingent on a “change in control”, that, when aggregated with all other “parachute payments” received by a disqualified individual (or “DI”) equals or exceeds three times the DI’s average annual compensation for the five years preceding the change in control (the “Base Amount”), unless an exception is otherwise available. If the DI receives parachute payments, then payments in excess of one times a DI’s Base Amount (the “excess parachute payment”) will generally become nondeductible to the paying corporation and subject to a 20% excise tax levied on the DI (the “Excise Tax”). For example, assume a base amount of $100, a resulting “three times” limit of $300 and aggregate parachute payments of $500; assuming no exceptions were otherwise available, the DI would have an excess parachute payment of $400 and be subject to an Excise Tax of $80.

SECTION I: TRANSACTIONS TRIGGERING PARACHUTE PAYMENTS

A. Change in Control

In order to have parachute payments under Section 280G, there must first be a Section 280G “Change in Control” (“CIC”). CIC transactions may occur in one of three forms:

i. Change in ownership: Any one person, or more than one person acting as a group, acquires stock resulting in ownership of more than 50% of the total fair market value (“FMV”) or total voting power of a corporation’s stock.

ii. Change in ownership of a substantial portion of a corporation’s assets: Any one person, or persons acting as a group, acquires, within a 12-month period, assets from the corporation with a total gross 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 (the “Asset Test”). An asset transfer is not treated as a CIC if before the transfer the corporation’s shareholders own more than 50% of the FMV or voting power of the acquirer.

iii. Change in effective control. If a transaction does not constitute a change in ownership or a change in ownership of a substantial portion of a corporation’s assets, there is a rebuttable presumption that a change in the effective control occurs on the date that, within a 12-month period, either (i) any one person, or persons acting as a group, acquires ownership of 20% or more of the total voting power of the corporation’s stock or (ii) a majority of the board of directors is replaced by directors whose appointment or election is not endorsed by a majority of the corporation’s board of directors before the appointment or election date. Absent these events, there is a rebuttable presumption that a change in effective control did not occur. Where a shareholder holds more than 20% of a corporation’s voting power, the acquisition of additional voting power does not trigger a subsequent change in ownership or change in effective control.

1. Under What Circumstances Can a Merger Be Treated As A CIC?

A merger will typically trigger a “change in ownership” of one of the two merging companies. In determining whether persons are “acting as a group”, Code Section 318 constructive
ownership rules apply. Where a shareholder owns stock in both corporations that are party to the merger ("Corporation A" and "Corporation B"), the "overlapping shareholder" is deemed to be acting with a group only with other Corporation A shareholders for its Corporation A shares, and only with other Corporation B shareholders for its Corporation B shares. Thus, in a "merger of equals", exactly one (and not both) of the corporations involved may undergo a CIC.

In practice the "smaller" corporation—measured by the proportion of stock received in the combined company—will be treated as undergoing the CIC.

2. Under What Circumstances Can An IPO Be Treated As A CIC?

The sale of a corporation's shares to unrelated buyers in a public offering usually would not result in a CIC, since persons are not deemed to be acting as a group "merely because they happen to purchase or own stock of the same corporation at the same time, or as a result of the same public offering." The sale of a corporation's shares in connection with a public offering would trigger a CIC, however, if any single person (or persons acting in concert) acquired ownership of shares constituting 50% or more of the corporation's value or voting power, including through accretion resulting from anti-dilution provisions or the retirement or redemption of stock. In addition, if any single person (or persons acting in concert) purchased 20% or more of the corporation's total voting power, then a CIC would be presumed (but could be rebutted if other control rights were not present).

3. Under What Circumstances Can A Subsidiary Sale Be Treated As A CIC?

Section 280G treats as a single corporation all members of an affiliated group of corporations, within the meaning of Code Section 1504 (an "Affiliated Group"). Whether the sale of a subsidiary corporation's stock triggers a CIC depends on whether the subsidiary is a member of the parent's Affiliated Group.

i. Subsidiary is an Affiliated Group Member. The sale of a subsidiary's stock is treated as a transfer of the parent's assets, and a CIC of the single collective "corporation" will occur only if the gross FMV of the subsidiary's stock is equal to or greater than one-third of the value of the total gross FMV of the combined corporation's assets, measured by the Asset Test (e.g., the FMV of the subsidiary's stock equals or exceeds one-third of the value of all of the corporation's assets). In that case, there would be a CIC of both the selling parent and the subsidiary.

ii. Subsidiary is Not an Affiliated Group Member. A subsidiary may not be a member of a parent's Affiliated Group, for a number of technical reasons in the way that Affiliated Group is defined for purposes of the tax rules. For example, the subsidiary may not meet the requirement that it be owned or controlled 80% by the parent corporation, the subsidiary may not be a corporation (e.g., is a partnership) or the subsidiary may be a corporation but the "chain" of corporations linking it to the parent is broken by an intervening partnership. Under a strict reading of the rules, if the subsidiary is not an Affiliated Group member, the parent and subsidiary should each be separately considered to determine which, if either, has undergone a CIC. For the subsidiary, the change in ownership or effective control rules apply, and for the parent, the Asset Test will continue to apply. Because the rules apply separately, it is possible to have a CIC of either, both or neither of the parent and subsidiary.

Issues arising for a partnership subsidiary are discussed in I(B), below. If the reason that the subsidiary is not an Affili-
ated Group member is because there is a 100%-owned partnership between the parent and subsidiary, it is not clear if a strict reading of the Affiliated Group rules is appropriate. In this circumstance, if the strict reading is applied, then the private company shareholder vote exception may be available.

4. What Types of Evidence May Be Used to Rebut The Presumption That A “Change in Effective Control” Has Occurred?

The change in effective control presumption may be rebutted by establishing that an acquisition of stock or change in board membership does not transfer from any one person (or group of persons acting in concert) to another the power to directly or indirectly control the corporation’s management and policies. The facts and circumstances that may be marshaled to rebut the presumption are case-specific, and in some situations the nature of required evidence—or the ability to rebut the presumption—may be unclear. Factors that the IRS has accepted as supporting rebuttal in a majority director change include that directors were replaced pursuant to successive proxy contests by unrelated groups, or that replacement directors were chosen by pre-change shareholders or the pre-change board of directors. Factors considered by the IRS in a 30% voting power acquisition included whether: substantial stock ownership remains with pre-change management; the purchaser’s interest would dilute to less than 20% over a relatively short period (based on, for example, employee stock option exercises); the purchaser’s shareholders or employees will hold management positions; and, post-CIC, the corporation might compete with other businesses owned or invested in by the purchaser.

It may be unclear whether a change in effective control has occurred, even if there was in fact a change in the majority of directors. Consider a threatened proxy contest ended by a settlement agreement resulting in a change in the majority of incumbent directors. The appointment of new directors would typically be approved by a majority of the corporation’s pre-change board members, despite the fact that a transfer of power to directly control management and policies of the corporation may have occurred. A plain reading of the Final Regulations supports the view that no change in effective control occurred, although there could be factors present that potentially weaken this position (for example, if the new directors were all controlled by a single person or group of persons acting in concert).

5. Under What Circumstances Can A Bankruptcy or Reorganization Transaction Be Treated As A CIC?

A bankruptcy transaction may trigger a CIC, although most bankruptcy transactions alone typically would not. For purposes of meeting the requisite 50% ownership and 20% effective control thresholds, creditors’ stock holdings are not aggregated merely because creditors are represented by a creditors’ committee or because creditors receive stock in the reorganization in proportion to their debt. Instead, there must be an intention for creditors to act as group to control the debtor. Service of a creditor’s representatives on a creditors’ committee will not alone constitute a group action. As long as creditors’ acquisitions of stock or assets are involuntary (e.g., provided in settlement of the corporation’s debt), a single creditor would need to obtain control of at least 20% of the stock or one-third of the debtor’s assets before a CIC (or presumption) would be triggered. Similarly, the replacement of the majority, or all, of the corporation’s board
with the approval of the pre-reorganization board would typically not trigger a CIC.15

B. Application to Non-Corporate and Foreign Entities

Section 280G applies to "corporations", regardless of whether publicly-traded. Certain privately-held corporations are eligible for an exemption. A Section 280G "corporation" includes a Code Section 7704(a) publicly-traded partnership, a Code Section 856(a) real estate investment trust, a mutual or cooperative corporation, a foreign corporation and a tax-exempt Code Section 501(a) corporation. “Small business corporations” under Code Section 1361 (“S Corporations”) are exempt from Section 280G, and payments from an S Corporation, a corporation eligible to elect to be an S Corporation, or a corporation that would be eligible for such election but for the Section 1361(b) prohibition on nonresident alien shareholders are, in each case, exempt from the "parachute payment" definition.16 In addition, a tax-exempt corporation under Code Section 501(c)(1), 501(c)(29), 501(d) or Section 529 is not subject to Section 280G.

1. How Are Partnerships Treated?

In general, Section 280G does not apply to payments that are contingent upon a change in ownership or effective control of a partnership (including a limited liability company—“LLC”—that has not elected to be taxed as a corporation) or a change in a substantial portion of a partnership’s assets. Section 280G’s partnership exemption is implicit, not express. First, only a corporation may experience a CIC (within the meaning of Q&A-27, 28 and 29), and parachute payments, by definition, must be contingent on a CIC of a corporation. Second, for most purposes under Section 280G all members of an Affiliated Group are treated as a single corporation, including for purposes of determining DIs; partnerships cannot be members of an Affiliated Group, and payments to partnership employees that are contingent on a change in control of the partnership would not be subject to Code Section 280G. And third, a “disqualified individual” is a shareholder, officer or highly-compensated individual of a corporation; a partnership cannot have DIs.17

There are no Revenue Rulings, Private Letter Rulings or other IRS guidance regarding Section 280G’s applicability to partnerships, but if a group of entities comprised solely of partnerships undergoes a change in control, Section 280G and Section 4999 would not apply. Where a group of entities under common ownership includes both partnerships and one or more corporations, the analysis can become more complex. In certain situations, there is at least a theoretical possibility that Section 280G could apply. Factors that impact whether Section 280G could apply with respect to such a group include the relative location, composition and roles of any corporations in the ownership group and whether any individuals could be deemed to be DIs of such corporations. Consider the following common structures:

i. Partnership Parent with Corporate Subsidiaries. A sale of a company comprised of a partnership parent with corporate subsidiaries should generally not implicate Sections 280G or 4999 where employees are employed by, perform services for and receive compensation from the partnership. Certain facts may increase the risk that Section 280G could apply, such as whether an individual is employed by or performs a substantial portion of his or her services to the corporation (versus the parent partnership) or receives compensation from the corporation,
so that the individual could be deemed to be a DI of that corporation. The risk of Section 280G’s application also increases if there are substantial operations or assets housed at, or income generated by, a subsidiary corporation such that the partnership is primarily a holding company, or if the parent-partnership were put in place shortly before a sale (such that the IRS could view the establishment of the partnership skeptically under partnership anti-abuse rules).

A partnership parent’s sale of a corporation’s shares would result in a CIC of the subsidiary corporation under the general Section 280G rules if the respective change in ownership or effective control thresholds were triggered, although adverse consequences would result only if there were parachute payments made to DIs of the subsidiary corporation. If the subsidiary corporation had corporate level employees or compensation obligations, parachute payments could result to the extent the payments were contingent on a CIC (or, as discussed in Section III.B below, and event “closely associated” with a CIC) of the subsidiary corporation. Moreover, as described above there is also a risk that an employee of the parent partnership could be deemed to be a DI of the subsidiary corporation if the individual performs substantial services for or receives compensation or other payments from the corporation.18

ii. Corporate Parent with Partnership Subsidiaries. There is a higher likelihood that Section 280G could be applied in a scenario where a corporate parent owns one or more partnership subsidiaries. If the corporate parent is sold, and employees are employed by, work solely for and receive compensation solely from an operating partnership, is Section 280G triggered? First, for Section 280G to apply, payments must be made to a DI; if none of the partnership employees are deemed to be DIs of the parent corporation, there would be no parachute payments and Section 280G would not apply (although any partnership employee who was an officer or 1% shareholder of the corporation would be a DI). Second, parachute payments must be contingent on the CIC of a corporation; if all payments are made from a partnership and there are no payments determined to be contingent on the CIC of the corporation (or an event closely associated with the CIC of a corporation), Section 280G should not apply. If payments are made from the corporation, however, the risk of Section 280G’s application increases, provided, of course, that payments were made to an individual deemed to be a DI, most notably in the case of a partnership employee serving a parent corporation officer.

In addition, a corporate parent could experience a CIC if it sold partnership interests exceeding one third or more of its gross asset value (determined per the Asset Test rules). In that case, parachute payments could result for DIs of the corporation, including any partnership employees deemed to be DIs of the corporation.

The risk that the IRS would apply Section 280G to a non-corporate entity in circumstances similar to those described above is unclear. In some instances affected companies may be able to take advantage of the private company shareholder vote that would permit them to eliminate any resulting parachute payments (which is discussed in detail in Section V of Part II of this article). Accordingly, in complex ownership structures with a meaningful level of uncertainty regarding the applicability of Section 280G, it may be prudent to consider whether a Section 280G shareholder vote would be appropriate.
2. Does Section 280G Apply to Non-U.S. Companies?

There is no specific exception under Section 280G for non-U.S. companies or persons, and foreign corporations may be included in an Affiliated Group. A transaction involving a non-U.S. entity treated as a “foreign corporation” under Code Section 7701(a)(5) could be subject to Section 280G if it either (1) employs U.S. taxpayers who would be DIs or (2) would have U.S. tax deductions for compensation paid to individuals who would be DIs. The disallowance of a deduction under Section 280G is not dependent on the imposition of the Excise Tax, and vice versa, so even a transaction involving two foreign corporations that do not otherwise have a U.S. component could raise Section 280G issues if the CIC corporation has DIs subject to U.S. tax.19

It is not always clear, however, whether a DI is in fact subject to U.S. tax, or whether there is a U.S. compensation deduction at risk of non-deductibility. In general terms, U.S. taxpayers include U.S. citizens and resident aliens who are subject to U.S. tax on their worldwide income. Otherwise (such as for a non-resident alien), a person is only subject to U.S. tax on income effectively connected to a U.S. trade or business.

A common scenario implicating Section 280G is a foreign parent’s sale of a U.S. subsidiary. Since an Affiliated Group includes foreign corporations under Code Section 1504(b), this scenario would typically only trigger a CIC under the Asset Test (although the parent’s organizational chart should be reviewed to confirm that the U.S. subsidiary is in fact part of the parent’s Affiliated Group). Section 280G could also raise less obvious issues in the case of a foreign corporation without U.S. operations, where any DIs subject to U.S. tax could be liable for the Excise Tax, even though there is no U.S. compensation deduction at risk (and conversely, a U.S. parent with non-U.S. DIs may lose a deduction, but DIs who are not U.S. taxpayers would not be subject to the Excise Tax).

SECTION II: DISQUALIFIED INDIVIDUALS AND BASE AMOUNTS

A. Disqualified Individuals

A DI is any individual who, at any time during the twelve-month period ending on the CIC date (the “DI Determination Period”) is an employee or independent contractor (including a director) of the corporation and with respect to the corporation, is (1) a 1% shareholder, (2) an officer or (3) a “highly-compensated individual”.20

i. 1% Shareholders. A shareholder who performs services (as an employee or independent contractor) for the corporation and actually or constructively (under Code Section 318(a)) owns more than 1% of the FMV of all classes of the corporation’s stock is considered a DI.

ii. Officers. An “officer” is an administrative executive who is in regular and continued service, and includes an individual who is an officer of any member of the corporation’s Affiliated Group.21 The “officer” title is not dispositive, but carries a presumption that the individual is an officer (and an executive without an “officer” title may be an officer). The “officer” determination is based on the relevant facts and circumstances, including the source of the individual’s authority, the term of the individual’s election or appointment, and the nature and extent of the individual’s duties, as well as other case-specific factors.

Up to 50 officers may be DIs or, if less, the greater of three employees and 10% of the corporation’s total employee headcount, determined based
on the greatest number employed during the DI Determination Period by the worldwide Affiliated Group (including employees who are not U.S. taxpayers, but excluding employees who are only employed on CIC date). If the number of officers exceeds the maximum number determined above, then the highest-paid number of officers is treated as DIs.

In smaller corporations where there may be potentially more DIs on account of officer status than highly-compensated employee status, the “officer” determination analysis becomes more important since the subjectivity of the Section 280G “officer” standard could result in an overstatement of the number of DIs. Although the Section 280G “officer” standard is not exactly the same as the standard used to determine Exchange Act Section 16 officers or Code Section 409A “specified employees”, in general the Section 280G “officer” list would typically be expected to be limited to those persons who are “executive officers” under Section 16.

iii. Highly-compensated individuals. A highly-compensated individual is an employee (or independent contractor) who is a member of the group consisting of the lesser of highest paid 1% of the employees or highest paid 250 employees of the Affiliated Group basis, ranked based on compensation earned during the DI Determination Period. The list of highly-compensated individuals may (and likely will) overlap with (but is not increased by) the list of officers.

1. Can An Individual Who Is Not A Current Employee or Independent Contractor Be A DI?

A former employee, director or independent contractor is a DI if at any time during the 12-month period preceding the CIC, the individual qualifies as a DI as described above. This may include an individual who dies before a CIC but whose estate receives parachute payments.

2. What Compensation Is Considered in Determining Whether An Individual or Entity Is An “Officer” or “Highly-Compensated Individual”?

The DI determination considers compensation that is not contingent on the CIC that is earned for services performed for the corporation undergoing the CIC, or a predecessor or related entity. “Compensation” is determined without regard to Code Sections 125, 132(f)(4), 402(e)(3) and 402(h)(1)(B), and therefore includes elective or salary reduction contributions to a cafeteria plan, cash or deferred arrangement or tax-sheltered annuity, and amounts credited under a non-qualified deferred compensation plan (which are typically reported in “Box 11”, and “Box 3” and/or “Box 5” of form W-2). For directors and independent contractors, compensation is determined based on amounts reported on form 1099.

B. Determination of Base Amount

A DI’s “Base Amount” is the DI’s average annual compensation includable in gross income for the five completed calendar years preceding the CIC date. If the DI has not been employed by the corporation for five full calendar years, Base Amount is calculated using only years in which the DI was employed.

1. How Are Partial Years Treated for Purposes of Base Amount?

Generally, for partial years of employment, compensation must be annualized, other than one-time or non-recurring payments such as sign-on or taxable relocation bonuses, which are included at face value. Annual compensation in respect of a partial year (but paid in a subsequent year) is not eligible to be annualized. For example,
consider a DI hired on July 1 of year 1, with a $250,000 base salary and target bonus equal to 100% of base salary; as of December 31 of year 1, the DI had actually been paid $125,000 in salary which would be annualized to $250,000. If a pro-rated $125,000 bonus is paid (and includable in income) in year 1, the bonus payment would be annualized as well (for total annualized compensation of $500,000), but if, under the more typical fact pattern, the bonus was not actually paid (and includable in income) until year 2, then only the year 1 salary would be annualized (for total annualized compensation of $250,000).25

2. What Is the Impact of A Section 83(b) Election on The Calculation of A DI’s Base Amount?

A DI’s Base Amount includes amounts included in income pursuant to a Code Section 83(b) election.26 Situations may arise where an item of compensation results in both income inclusion for Base Amount determination and a parachute payment. For example, the value of a restricted share for which an 83(b) election was made would be included in Base Amount, and the value of any accelerated CIC vesting would constitute a parachute payment.

3. Is Deferred Compensation Included in A DI’s Base Amount?

Base Amount only includes compensation includible in income under federal income tax principles. As a result, deferred compensation is included in Base Amount in the year paid, regardless of when it was earned.27

4. How Is Base Amount Determined for DIs Who Are Not Current Employees?

Although not required by the Final Regulations, a DI’s Base Amount is often determined by reference to the amounts reported in “Box 1” on the DI’s Form W-2. The analysis may become more complicated where an individual is not issued a W-2. For a non-employee director or consultant, Base Amounts may be determined by reference to the compensation reported on Form 1099. The Base Amount for a DI who is not a U.S. citizen or resident is determined in a manner consistent with the normal rules, and includes the amount that would have been includible in gross income if the DI had been a U.S. citizen or resident.28 The determination often requires multiple assumptions regarding the nature of payments made to such non-U.S. DIs, especially in jurisdictions where pension, health and welfare benefits may be highly government subsidized and the jurisdiction may not have a uniform wage reporting mechanism.

5. What Types of Employees Are Likely to Have Artificially Low Base Amounts?

There are three common categories of employees who will often have base amounts that are materially lower than their actual compensation: (1) newly-hired employees (because they have not yet realized much of their actual compensation), (2) recently or rapidly promoted employees (because their average realized compensation has not caught up with their current compensation) and (3) employees primarily compensated with non-taxable compensation such as employees compensated with stock options who have chosen to hold their options instead of exercising them (because there is no realized compensation from the options until exercise) or employees who have elected to defer compensation or employees who have received compensation in the form of property taxed as capital gains (e.g., profits interests). These people are often the hardest hit by the Section 280G rules.
6. Is Compensation From A Predecessor Company Included in Determination of A DI’s Base Amount?

Yes. A DI’s base amount includes compensation for services performed for a predecessor entity or a related entity of the corporation undergoing the CIC. A “predecessor entity” is any entity which has transferred some or all of its employees to the CIC corporation as a result of a corporate transaction, asset transfer, separation or other business transfer. A “related entity” includes (1) all members of a Code Section 414(b) “controlled group of corporations” (as opposed to an Affiliated Group), (2) all trades or businesses under common control within the meaning of Code Section 414(c), (3) all members of a Code Section 414(m) affiliated service group and (4) any other entities required to be aggregated with the CIC under Code Section 414(o) (other than “leasing organizations” as defined Code Section 414(n)).

SECTION III: COMPOSITION OF “PARACHUTE PAYMENTS”

A “parachute payment” must be both (1) a payment in the nature of compensation and (2) contingent on a CIC, that (3) when aggregated with all other payments to a specified DI, has a present value of at least three times the DI’s Base Amount (the “Three-Times Test”). Parachute payments include payments and benefits triggered directly by a CIC, certain severance payments made upon an employment termination after (and in some cases before) a CIC and the value of accelerated vesting or payment of cash or equity compensation or other benefits in connection with a CIC.

A. Payments in The Nature of Compensation

1. What Constitutes A “Payment in The Nature of Compensation”?

Payments “in the nature of compensation” include all payments, in any form, arising from an employment relationship or associated with performing services (including holding oneself out as available to perform services or refraining from performing services). Compensatory payments include:

- wages and salary, bonuses and other cash compensation (or the right to receive cash);
- severance pay and benefits;
- fringe benefits, life insurance and deferred compensation;
- a transfer of property (or the right to receive a property transfer); and
- the value of accelerated vesting or payment of cash or a transfer of property.

Examples of non-compensatory payments may include cancellation of a non-lapse restriction on a stock option and attorney’s fees and court costs incurred in connection with a parachute payment. Payments pursuant to a “tax receivables” agreement (or similar arrangement used to account for a step-up in the partnership basis of a subsidiary partnership interest upon the conversion to shares of a parent corporation) would typically be treated as a non-compensatory payment.

A compensatory payment is generally considered made in the tax year that it is includible in the DI’s income or, for non-taxable fringe or other benefits, in the tax year received. Special rules apply—and unique issues arise—for payments resulting from transfers of property (such as restricted stock) or a stock option. A parachute payment for stock options, restricted stock units, restricted stock or other property occurs when the property
vests, without regard to whether a Code Section 83(b) election has been made. Accordingly, as noted in Section II, a parachute payment for restricted stock (or other restricted property), restricted stock units or stock options may arise if the property’s vesting or payment schedule accelerates as a result of a CIC, even though the DI included (or will include) related income in a different year.

2. Can The Grant or Vesting of A Partnership Profits Interests Result in Parachute Payments?

Section 280G’s impact on “profits interests” granted by a partnership is not always clear. Like stock options or restricted stock, profits interests may be subject to a vesting schedule (and vesting may accelerate on a CIC), and once vested represent the right to receive distributions in respect of partnership income and/or to participate in the appreciation of the partnership’s value after the grant date. A partnership profits interest award is considered to be property, similar to restricted stock, although in most instances profits interests are not taxable at grant or vesting (and generally do not produce any compensation income or deduction).

In most situations, Section 280G would not apply to payments arising from a transaction involving a partnership, although as described above, in certain circumstances Section 280G may be triggered. If Section 280G does apply to a transaction in which DIs hold partnership profits interests, accelerated vesting of profits interests could (depending upon the facts) potentially generate parachute payments, even though profits interests do not otherwise produce any compensation income. As payments in respect of profits interests are not deducted by partners, the real concern is the Excise Tax imposed on the DI holding the award.

In certain circumstances, there may be a mismatch between parachute payments arising from partnership profits interests and amounts included in a DI’s Base Amount. Payments in respect of partnership interests are typically not treated as ordinary compensation income for tax purposes, and are not reported in a DI’s Form W-2.

Issues regarding profits interests nearly always arise in the private company context, and accordingly, the private company voting exemption is often available to eliminate any Section 280G liability.

3. Do Any CIC Related Changes to A Stock Option Trigger A Parachute Payment?

Parachute payment treatment of stock options (and SARs) departs from the general rule that a payment is considered made when the DI includes the resulting compensation in income. Income recognition for an option occurs at exercise, and the amount includible in income (for a non-qualified option) is the excess of the underlying stock’s FMV on the exercise date over the option’s exercise price. For Section 280G, a “compensatory payment” in respect of a stock option occurs when the option vests or is otherwise not subject to a “substantial risk of forfeiture” under Code Section 83(c), so accelerated vesting of an option on a CIC generally gives rise to a parachute payment. Money or property transferred to the DI after vesting, upon exercise or as consideration on the option’s sale or disposition is not treated as a “compensatory payment” under Section 280G.

An interesting issue can arise in connection with a stock option that provides for an extended exercise period after a CIC. Consider a stock option that provides for a three-month post-employment termination exercise period before a CIC,
and exercise for the full remaining option term upon an employment termination after a CIC. Notwithstanding the fact that the extended exercise period does provide the option holder with additional, measurable economic value, the Final Regulations state that a “payment” in respect of a stock option occurs at vesting, and such payment is valued at that time.\(^3\)

Although the Final Regulations do not expressly state that vesting is a stock option’s exclusive payment event, nothing in the Final Regulations provides that the extension, per an option’s previously existing terms, of the post-termination exercise period constitutes a “payment”. Section 280G’s legislative history also supports the position that grant and vesting are the exclusive times at which a “payment” in respect of a stock option may occur.\(^3\)

4. Can Non-Taxable Employee Benefits Give Rise to Parachute Payments?

Although non-taxable benefits do not contribute to a DI’s base amount, certain CIC-contingent benefits, such as post-termination subsidized or employer-paid health coverage, will generally constitute compensatory payments for Section 280G and can result in parachute payments. Under the Three-Times Test, the present value of the corporation’s obligation, calculated in accordance with GAAP, may be used to measure the continued coverage value by projecting premium costs for purchased health insurance, even if no insurance is actually purchased.

5. How Are Benefits Under Tax-Qualified Plans Treated?

Taxable benefits payable to or from a retirement plan qualified under Code Section 401(a) following a post-CIC employment termination do not constitute parachute payments, although accelerated vesting or the grant of additional age and service credit under a non-qualified SERP generally would. The broad exception for payments from tax-qualified retirement plans provides a well-known (but seldom used) opportunity to reduce parachute payments by paying CIC amounts under a 401(a)-qualified plan (subject to qualified plan limits, Code Section 409A requirements and other applicable constraints). This approach is often referred to as a “Q-SERP”.

B. “Contingent” Upon A Change in Control

A payment is treated as “contingent” on a CIC if it is paid, becomes vested or is accelerated (a “payment event”) as a result of either (1) the CIC or (2) an event that is both (a) “closely associated” with, and (b) “materially related” to, the CIC. A payment event is treated as resulting from the CIC unless it is substantially certain at the time of the CIC that the payment event would have occurred without regard to the CIC.\(^4\) Under a separate rule, payments made under an agreement entered into (or modified in any significant respect) within one year before a CIC are presumed to be contingent on the CIC, unless it is demonstrated by clear and convincing evidence that the payments were not in fact contingent on the CIC.\(^4\)

1. When Does A “Closely Associated” Event Result in A Parachute Payment?

Even if not directly contingent on a CIC, a parachute payment may result if it is contingent on an event that is “closely associated” with a CIC, and the event is “materially related” to the CIC. “Closely associated” events are of the type “often preliminary or subsequent to, or otherwise closely associated with” a CIC, determined based on all the facts and circumstances of a particular case.\(^4\) The Final Regulations provide a non-exclusive list of seven “closely associated” events as

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examples: (1) a termination of a DI’s employment; (2) a significant reduction in the DI’s job responsibilities; (3) a “CIC” as defined in a DI’s employment arrangements (even if it does not constitute a Section 280G CIC); (4) the onset of a tender offer; (5) a “substantial increase in the market price of the corporation’s stock that occurs within a short period before” a CIC; (6) the delisting of a corporation’s stock from an established securities market; or (7) the acquisition of a person or group of more than 5% of the corporation’s stock by a person (or group) not in control of the corporation.

IRS guidance also provides examples of events that are not closely associated with a CIC, including the sale of a subsidiary occurring shortly before a parent’s CIC where the decision to sell the subsidiary was made before an unsolicited offer to buy parent, an increase in the level of sales or profits unrelated to the CIC or an announcement of the CIC, or payments triggered upon confirmation of a reorganization plan in bankruptcy. However, because the ultimate question of whether an event is (or is not) closely associated with a CIC under Q&A-22(b)(2) is determined based on all of the relevant facts and circumstances surrounding the event, other events may in fact be deemed to be “closely associated” with a CIC.

2. Is The Signing of A Merger Agreement “Closely Associated” With A CIC?

Although Q&A-22(b)(2) does not list as a “closely associated” event the entry into the transaction agreement pursuant to which the CIC occurs, the signing of the agreement is in fact “often preliminary or subsequent to, or otherwise closely associated with” a CIC, and as such would appear to typically be a “closely associated” event. There may be situations, however, when payments that are granted or made concurrent with the entry into transaction agreement are not necessarily parachute payments if, for example, it could be demonstrated that the payments would have been granted or made absent entry into the agreement. In addition, as discussed below, there is a presumption that an event which occurs more than one year before a CIC is not “materially related” to the CIC. In that case, absent evidence to the contrary, even if entry into a transaction agreement were “closely associated” with the CIC, a payment made contingent on such entry would not be a parachute payment unless the signing was demonstrated to be “materially related” to the CIC.

3. When Is An Event “Materially Related” to A CIC?

A “closely associated” event must be “materially related” to the CIC in order for it to result in parachute payments. In general, whether a material relationship exists is determined by the timing of the event relative to the CIC, taking into account all relevant facts and circumstances. A “closely associated” event that occurs during the one year preceding or following a CIC is presumed to be “materially related” unless demonstrated otherwise. A converse assumption in favor of the taxpayer also applies: if the event occurs outside of the one-year period preceding or following the CIC, the event is presumed not to be “materially related” to the CIC. This rule is often confused with the one-year lookback under Q&A-25, under which parachute payment status is based on whether the agreement pursuant to which a payment was made was entered into or amended within the one year preceding the CIC. In contrast,
Q&A-22’s “materially related” presumption is based on whether the payment-triggering event occurs during the one-year period preceding (or following) the CIC.

The Final Regulations do not state the evidentiary standard for rebutting the “materially related” presumption. In comparison, “clear and convincing evidence” is required to rebut the one-year lookback rule under the statute and Q&A-25 (which, discussed below, is similar to and sometimes confused with the Q&A-22 one-year presumption). Consequently, a lower rebuttal standard may apply to the Q&A-22 presumption.

4. When Does An Employment Termination Result in Parachute Payments?

Employment termination is one of the more common “closely associated” events encountered in practice. Termination of employment is considered “closely associated” whether voluntary (e.g., a retirement) or involuntary (termination by the employer without “cause” or by the DI for “good reason”). However, termination timing and the terms of the applicable severance arrangement dictate whether severance payments are in fact treated as parachute payments that are “materially related” to the CIC.

i. No CIC Enhancement. If a CIC does not affect the amount of a DI’s severance entitlement (for example, severance is equal to two times base salary, regardless of whether a qualifying termination occurs before or after the CIC), then employment termination within the one-year preceding or following a CIC is presumed to materially relate to the CIC, such that all severance amounts would be parachute payments (absent another exception or the ability to rebut the presumption). Conversely, employment termination after the first anniversary of (or more than one year before) the CIC, is presumed, in favor of the taxpayer, to be not “materially related” to a CIC, although the IRS may rebut that presumption if facts and circumstances prove otherwise.

ii. CIC Only Severance. If severance is payable only after (or in connection with) a CIC, an employment termination that triggers CIC severance will be treated as “materially related”, and the presumption is unrebuttable. As a result, any such CIC-only severance, regardless of when paid (and regardless of whether the qualifying employment termination occurs within the one year before or after a CIC), will constitute a parachute payment.47

iii. CIC Enhanced Severance. If severance arrangements provide for both non-CIC severance and enhanced CIC severance, the analysis becomes more complex. For example, an arrangement may provide for severance equal to one-times salary in the non-CIC context, and three-times salary during the two-year period after a CIC (for a two-times enhancement). In that situation, if employment termination occurred within one year after a CIC, the one-times portion would be presumed to be a parachute payment and the enhanced two-times portion of severance would be treated as a parachute payment. However, if the termination occurred between the first and second anniversary of the CIC, the one-times portion would be presumed to be not “materially related” to the CIC and therefore not a parachute payment, but the enhanced two-times portion of severance would be treated as a parachute payment.

iv. Factors Impacting the One-Year Presumption. Examples of facts and circumstances that may be relevant to rebutting the presumption within the one year before or after a CIC could include
whether the termination was a result of changes in policies or strategy implemented by new ownership or management, or whether instead contributing factors were entirely independent of the change (such as a general business downturn or circumstance specific to an individual), or whether an event other than the CIC (or other “materially related” event), such as the DI’s performance, can be demonstrated to be the proximate cause of termination.

5. What is The Impact of New or Amended Agreements Entered Into Within One Year Before A CIC?

Q&A-25 provides that a payment made pursuant to an agreement entered into or modified in any significant respect within the one year preceding a CIC is presumed to be contingent on a CIC, unless the taxpayer establishes by clear and convincing evidence that the payment is substantially certain to have been made regardless of the CIC. Under this rule, even an agreement without a CIC trigger can generate parachute payments, and, if read literally, means that all payments made under the agreement could be deemed parachute payments. In practice, such a literal reading of the rule is often not applied. Instead, payments pursuant to such new or amended agreements often (1) occur in “ordinary course” circumstances that are eligible for rebuttal and/or (2) constitute “reasonable compensation” for pre- or post-CIC services (which is further discussed in Section IV of Part II of this article).

Factors considered in rebuttal include the agreement’s or amendment’s content and the circumstances surrounding its execution, whether it was entered at the time a potential CIC transaction had commenced and the degree of likelihood that the CIC would actually occur. Legislative history suggests that rebuttal could be impacted if the corporation thought it was likely to be sold. Common situations that may invoke the Q&A-25 lookback presumption, and considerations in establishing rebuttal evidence, include:

i. New or Materially Amended Employment or Severance Agreements. Payments under agreements either newly entered into or modified “in any significant respect” during the one year preceding the CIC are presumed to be contingent on the change. For example, a severance right newly created six months before a CIC could result in a parachute payment for an employment termination that occurs at any time after the CIC (provided that a CIC occurs within one year after creation of the new right), regardless of whether the severance trigger referred in any way to the CIC. The lookback presumption will generally be rebutted if the agreement or amendment (1) replaces a prior contract and provides no increased payments (other than normal increases attributable to increased responsibilities or cost of living adjustments) or (2) is an arrangement with a new employee that does not provide for payments significantly different in amount, timing, terms or conditions from those provided under contracts with similarly-situated employees in a non-CIC context. Consequently, it would be expected that the presumption would be rebutted in the case where a newly-promoted executive is provided with the company’s standard executive employment agreement. Modification in a “significant respect” is not defined by the Final Regulations, but should be limited to amendments that materially increase payments or benefits (although changes in ongoing compensation, such as salary and annual bonus, would not be expected to be swept in by the presumption). Where the presumption does apply, only the amount of any incremental severance increase should be (rebuttably) presumed to be contingent on the CIC.
ii. *Equity Awards.* Equity award grants, even routine, annual on-cycle grants and ordinary course new-hire grants may be captured by the one-year lookback presumption as a new compensatory agreement, if made during the one year before the CIC (even if made before the CIC was contemplated). If not rebutted, the full value of time-vested equity awards is presumed to be contingent on the CIC, and the value of such awards is not eligible for reduction pursuant to Q&A-24(c) (described below). Facts accepted by the IRS as clear and convincing evidence that grants are not contingent upon the CIC may include that grants:

- are not excessive compared to historical grants and that the aggregate FMV of the awards is consistent with the FMV of prior annual grants as a percentage of total compensation;

- have the same terms and conditions as prior annual grants and annual grants were historically made at the same time for several preceding years; and

- are intended to partially compensate the grantee for past services or are entirely forward-looking.

Other facts that could help rebut the contingency presumption where grants are larger or have different terms than past awards may include: that a DI is contractually entitled to equity grants pursuant to an agreement that was not entered into or amended during one year preceding the CIC; a history of increasing grants over time or that the larger grants result from improvements in the grantee’s performance or a change in roles or responsibilities; a history of varying terms; and that changes in terms result from tax or business considerations independent of Section 280G, such as the emergence from the Code Section 162(m) post-IPO transition relief period or adoption of a new equity incentive plan. For non-routine equity grants, such as promotion or new hire awards, an important consideration is how the value or number, terms and conditions of the awards compare to the corporation’s past non-acquisition grants to newly-hired or promoted employees.

Equity grants made between the signing of a transaction agreement and closing of the related transaction may be subject to heightened scrutiny, but as long as made in the ordinary course of business, consistent with past practice in amount and general timing, the presumption should be susceptible to rebuttal. Even if a company had previously granted stock options or performance share units, but between the signing and closing of a transaction granted time-vested restricted stock units otherwise on similar general terms and with a similar dollar value, it would be customary to treat such restricted stock units as rebutting the contingency presumption.

6. **Under What Circumstances Might The CIC-Year Annual Bonus Result in A Parachute Payment?**

Under Q&A-22, a parachute payment will result from any portion of an annual bonus that is not demonstrated by the taxpayer to be, as of the CIC date, substantially certain to have been paid regardless of the CIC. As a result, a CIC year bonus paid at the time and in the amount that would have been paid absent a CIC would not result in a parachute payment, although changes to either the amount or time paid may subject all or a portion of the payment to Section 280G. Consider an annual bonus that, in the case of a CIC, is paid based on the greater of target and actual performance under the following circumstances.
If a CIC year bonus payment is greater than the amount earned absent special CIC treatment (e.g., payment at target when actual performance would have resulted in a payment equal to 90% of target), the 10% excess would generally be contingent upon the CIC, under the general contingency rules of Q&A-22. To avoid treatment of the entire payment as a parachute payment and limit the portion of the bonus subject to Section 280G to the excess, the taxpayer must demonstrate (and quantify) the portion of the bonus that would have been paid absent the CIC.

The degree to which actual performance is demonstrable impacts the strength of arguments that the portion of the payment based on actual performance is not contingent. Numerous facts and circumstances impact a taxpayer’s ability to successfully identify the portion of the payment that would have been paid without regard to the CIC. Arguments may be more persuasive for bonuses paid at the time normally paid absent the CIC, while more difficult to make if the payment is made early in the bonus year, since the demonstration would likely require pro forma projections of what actual performance would have been (and accordingly, payments for CIC dates that occur later in the bonus year may be easier to exclude from Section 280G than for CIC dates earlier in the bonus year). The types of performance metrics applicable to the bonus, the extent to which performance goals are measurable after the CIC and the historic volatility in the company’s performance relative to the relevant metrics may also impact the ability to calculate performance absent the CIC.

In addition, if the CIC treatment under the terms of the company’s pre-existing bonus plans is modified during the year preceding the CIC (including pursuant to a merger agreement covenant or severance plan amendment), the Q&A-25 presumption and “clear and convincing” rebuttal standard would apply. Although the higher standard would appear to make it harder to argue that a portion of the payment would have been substantially certain to have been paid absent the CIC, there may not be much of a practical difference between the general “substantially certain” and the “clear and convincing standard”.

7. Are There Circumstances in Which Payments Pursuant to Post-CIC Agreements Can Generate Parachute Payments?

In general, payments are not treated as contingent on a CIC if made pursuant to an agreement entered into or amended after the CIC. There are, however, two situations where a post-CIC agreement may generate parachute payments: (1) a post-CIC agreement is entered into pursuant to a legally enforceable pre-CIC agreement and (2) a post-CIC agreement entered into in exchange for rights that existed under a pre-CIC agreement.

In the first situation, an agreement executed after a CIC “pursuant to a legally enforceable agreement” that was entered into before the CIC is deemed to have been entered into before the CIC under Q&A-23. The Final Regulations do not define “legally enforceable agreement” and whether a payment is “pursuant to” such an agreement may not always be clear. Legislative history suggests a broad lookback (contingent payments may be “pursuant to a formal or informal understanding reached before the change occurs”), while the Final Regulations and subsequent case law, discussed below, contemplate a narrower lookback.
Facts and circumstances that could impact the analysis of whether there was a "legally enforceable" pre-CIC agreement include whether the post-CIC agreement results from the restructuring of pre-CIC rights, the relative timing of discussions regarding an agreement and the degree of completion at the CIC date. For example, pre-CIC verbal discussions that result in a new agreement entered into shortly after the CIC should not be deemed to be "legally enforceable" under Q&A-25 absent a pre-CIC contractual entitlement. On the other hand, where parties negotiate and agree on all the terms for an agreement but delay execution until immediately post-CIC, depending on the facts, for this purpose there could be found to be a "legally enforceable" pre-CIC agreement.

In the second situation, if a DI has a right to receive a payment that would be a parachute payment if made under a pre-CIC agreement, and exchanges that right as consideration for payments or benefits under a post-CIC agreement, the payments are treated as parachute payments in an amount up to the value of the payments under the pre-CIC agreement. Payments in excess of the value of the pre-CIC payments, however, are not treated as parachute payments.

The restructuring scenario was addressed in Cline v. Commissioner (and later in the Square D case, discussed below), where DIs forfeited payments under pre-CIC agreements to bring total parachute payment amounts below the Safe Harbor. Concurrent with forfeiture, the acquirer gave the DIs verbal assurances that it would use "best efforts" to make the DIs whole for the foregone amounts. New agreements, executed after the CIC, provided for payments significantly greater than payments under the original agreements. Although the new agreements were entered into after the CIC, the court held that the "best efforts" assurances constituted a "legally enforceable" agreement within the meaning of the one-year lookback and payments under the new, post-CIC agreements were treated as parachute payments.

Although the court's holdings in Cline could be read broadly in a way that would expand the circumstances in which payments may be found to be "pursuant to a legally enforceable agreement", the more commonly accepted narrower reading (which is consistent with the Final Regulations) limits the holding of the case to situations where pre-CIC agreements are restructured after a CIC. The more limited reading is also consistent with the Square D holding which also addressed, in part, the question of "restructured" parachute payments, holding that "pursuant to" a legally enforceable agreement means that the pre-change arrangements were the proximate cause of post-CIC rights, such that but for the pre-CIC agreement, the rights under the post-CIC agreement would not have arisen.

C. Valuation of Parachute Payments

Three-Times Test. Adverse tax consequences under Section 280G and 4999 attach when the aggregate present value, as of the CIC date, of all parachute payments made to a DI equals or exceeds three times the DI's Base Amount (as described above, the "Three-Times Test"). If the Three-Times Test is met, then all of the parachute payments in excess of one times the Base Amount are "excess parachute payments" subject to loss of deductibility and the Excise Tax.

General Rule—Full Amount of Parachute Payment Included. A payment in the nature of compensation is generally considered to be made in the tax year in which it is includible in the DI's income (or for fringe benefits, the year...
the benefits are received). Absent certain exceptions (such as the special reduction for time-vested payments and reduction for reasonable compensation), the amount of the parachute payment equals the full amount of a payment contingent on a CIC (generally the amount includible in the DI’s income). Special rules apply to transfers of property (such as restricted stock), where the amount of includible income (and parachute payment) generally equals the excess of the FMV of the transferred property over the amount (if any) paid for the property when such property vests, calculated under Code Section 83 (ignoring any Code Section 83(b) election). Special treatment also applies to stock options, which are generally valued, as of the grant date or vesting date, at the option’s fair value (as defined below).

1. Are There Special Considerations in Determining The Present Value of A Payment for Section 280G?

The Three-Times Test requires that payments be measured based on their present value as of the CIC date, or if earlier, the payment date. As the Final Regulations do not prescribe any specific method for determining present value, conventional finance principles apply. For this purpose, the discount rate equals 120% of the applicable federal rate (“AFR”) at the relevant date. A DI and corporation may, at a contract’s inception, for Section 280G purposes applicable to payments under that contract, elect to use the effective AFR at the date the contract is entered into by memorializing the election in the contract. The present value of payments made in years after the CIC year is determined using “reasonable actuarial assumptions”, with the amount of the payment “discounted back” to the CIC date.

If a DI’s right to a payment is contingent on an event in addition to a CIC (such as a “double-trigger” severance condition), it may be uncertain at the CIC date whether a DI will actually receive that payment. The Final Regulations provide that if there is at least a 50% probability that an uncertain payment will be made, then the entire present value of the payment is considered for the Three-Times Test (and a later recalculation will be triggered if not actually made). If there is less than a 50% probability that the payment will be made, then the present value of the payment is not considered for Three-Times Test (but a later recalculation will be triggered if the payment is actually made later). If the Three-Times Test initially resulted in an excess parachute payment, without regard to the uncertain payment in question, and no Base Amount was allocated to such payment, then the later payment will automatically be treated as an excess parachute payment, without recalculation of the Three-Times Test.

2. How Is A Stock Option Valued?

Q&A-13 includes the general rules for valuing stock options, and provides that a stock option’s value is determined at vesting (or, in certain very limited circumstances, at grant) based on all the facts of circumstances of a particular case, including the option’s spread value, volatility and exercise period. Rev. Proc. 2003-68, issued concurrently with the Final Regulations, provides more detailed valuation guidance. In addition to a safe harbor method (similar to the Black-Scholes method), the revenue procedure permits valuation using any method consistent with GAAP that takes into account the Q&A-13 factors.

An exception to the general rule is that options cashed-out in a transaction should be valued at the stock option’s intrinsic spread value (subject to Q&A-24(c) reduction, as dis-
cussed below), because in that circumstance the other factors are not relevant because the option will not be exercisable after the transaction closes. Underwater options cancelled for no consideration should not result in parachute payments if the option is extinguished and there is no possibility of future payment, although any amount paid for cancellation of an unvested option would be a parachute payment. If stock options were rolled-over into new option awards on acquirer stock, the resulting parachute value equals the fair value of the option based on the relevant characteristics of the acquirer's stock, determined under an appropriate fair value method, subject to Q&A-24(c) reduction, as described below (with parachute payments for unvested options determined at vesting (or grant) as described above).

3. When Valuing A Stock Option, Under What Circumstances Must A Taxpayer Use The Stock Option’s Maximum Term Versus The Option’s Expected Remaining Life?

Q&A-13 requires that a stock option’s value must consider the length of the period during which the option can be exercised. As discussed above, a payment in respect of a stock option is determined at the option’s vesting date (including any accelerated CIC vesting). The Final Regulations permit three different approaches to stock option valuation, each of which may permit the use of a different remaining exercise period.

First, the general safe harbor provisions of Rev. Proc. 2003-68 state that a stock option’s term should be determined based on the number of full months between the valuation date and the “latest date on which the option will expire”, or the stock option’s maximum term. There are no specific circumstances that require the use of this method, which (other factors equal) most often results in the highest option (and parachute payment) value.

Second, Rev. Proc. 2003-68 also permits the use of the Rev. Proc. 98-34 safe harbor provisions, which permits use of the stock option’s “expected life”. The expected life is typically shorter than the maximum term, and other things equal, usually results in a lower parachute value than the Rev. Proc. 2003-68 safe harbor. But, if the stock option is exercisable for more than six months after employment termination, then the valuation must consider the stock option’s maximum term, consistent with the safe harbor. Accordingly, this approach would not be available to value a stock option with a post-termination exercise period extending more than six months.

Third, Rev. Proc. 2003-68 permits the use of any other valuation method that is consistent with GAAP and takes into account the factors provided in Q&A-13. Like the Rev. Proc. 2003-68 safe harbor, there are no specific circumstances that require the use of the non-safe harbor approach (also see discussion in Section III.A.3, above). Depending on the valuation method and assumptions employed, this approach provides the most flexibility in determining a stock option’s parachute value, resulting in a lower value than if the options’ maximum term is used (and a potentially lower value than using the option’s expected life). A common approach is to use the GAAP expected life ratio (expected life / 10-year option term) and multiply by the portion of the option term remaining as of the CIC in order to calculate the then-applicable expected life.
4. **Under What Circumstances May A Taxpayer Revalue A Stock Option (and The Amount of Any Parachute Payments or Excess Parachute Payments Arising from The Option)?**

In certain situations, after a CIC the assumptions initially used to value a stock option may change, such that the stock option’s value (and associated parachute payment) is lower than the value at the vesting date. For example, an option holder’s employment might terminate, resulting in a term shorter than assumed when the option (and associated parachute payment) was valued. In that case, a taxpayer who had previously paid the Excise Tax related to any excess parachute payment arising from the stock option would have overpaid.

Q&A-33 permits a taxpayer to revalue an option as provided by applicable guidance. Rev. Proc. 2003-68, in turn, permits revaluation under one of two circumstances, in either case occurring within the 18 months after a CIC: (1) the option’s term has changed as a result of employment termination; or (2) the volatility of underlying stock has changed. In either of these situations, the taxpayer is permitted (but not required) to revalue the option, but one of the situations must occur to permit revaluation (and the option may not be revalued simply because the option is exercised). The exercise of the option after the CIC or vesting does not permit the use of the option’s spread value (instead of the fair value approach required by Q&A-13).

An example in Rev. Proc. 2003-68 part 5 addresses revaluation triggered by a shortening of the option’s term due to an employment termination, but does not address a lengthening of the term (such as pursuant to an extended post-CIC exercise period—see discussion in Section III.A.3). This is not surprising for at least two reasons: first, the initial valuation of the option should have taken into account either the option’s maximum term, or, in certain circumstances, the expected term (which should have already factored-in events pursuant to the option’s contractual provisions that could have resulted in an extended term); and second, because revaluation is not mandatory, a rational taxpayer would not elect to revalue an option if parachute payments would increase.

The revaluation must be performed as of the payment date used in the initial valuation. Accordingly, other than the option’s term and stock volatility, other valuation assumptions (e.g., intrinsic value, interest rate) must continue to be determined consistent with the initial valuation. A taxpayer may use a revaluation method other than that initially used to value the option, as permitted under Rev. Proc. 2003-68. If a taxpayer elects to revalue an option, parachute payments (including any amounts initially determined under Q&A-24(c)) and excess parachute payments must also be recalculated. The taxpayer is not required to reapportion the Base Amount, so only the Exercise Tax amount is adjusted. To claim the adjustment, the taxpayer must file an amended return for the tax year in which the option’s original payment date occurred. The exercise of an option after a CIC, however, does not permit revaluation.

**Special Rule for Time-Vested Compensation that Vests in Connection with a CIC.**

Generally, if a payment is contingent on a CIC, the full amount is treated as a potential parachute payment. A reduced amount is possible to the extent that (1) the payment becomes vested as a result of the CIC, (2) in the absence of the CIC the payment was contingent only on the continued performance of services and (3) a portion of the payment is attrib-
utable to the performance of pre-CIC services. This is commonly referred to as the “Q&A-24(c) discount”.

If the Q&A-24(c) discount applies, the resulting parachute payment is equal to the sum of (1) 1% of the present value of the payment vesting on the CIC, multiplied by the full number of months between the actual vesting date and the date that the payment would have vested absent the CIC acceleration plus (2) an interest charge for the acceleration in payment timing. The reduction is most commonly applied to equity awards (such as options, restricted stock or restricted stock units) that vest subject to the grantee’s continued service, but may also apply to cash payments (such as bonuses with guaranteed amounts that are accelerated in connection with a CIC). For example, in very simplest terms, if an option is cashed-out upon the closing of a CIC for $100, and the option otherwise would have vested 24 months after the closing, the parachute payment value is equal to the sum of (1) the $24 value of the lapse of the restriction of 1% times $100 times 24 months plus (2) the $2 of the payment acceleration (equal to $100 times an assumed 1% annual interest rate times w years), or $26, instead of the full $100.

1. Can A Payment With A Performance-Vested Component Be Subject to Q&A-24(c)?

In general, the reduced value provided under Q&A-24(c) does not apply to payments that vest based on any event other than continued service. As a result, the entire amount of a performance-vested payment may constitute a parachute payment if it vests contingent on the CIC. Neither the Q&A-24(c) discount for accelerated payment nor accelerated vesting may be applied to a payment if (without regard to the CIC) vesting or acceleration depends on an event other than the performance of services, such as the attainment of a performance goal, and the event does not occur before the CIC.

However, the discount is available for a payment that vests contingent on the CIC to the extent that the payment requires further services; thus, if the performance period for an award is incomplete but performance goals have been (or are substantially certain to be) met and continued service is required for payment, the Q&A-24(c) discount should be available to the extent that only service-based vesting accelerates. Facts and circumstances determine whether that position can be supported in a particular case, and include how much of the performance period has been completed, whether performance measures have been conclusively met and the determinability of performance achievement at a given mid-point in a performance period.

2. Can Compensation Valued Under Q&A-24(c) Be Further Reduced by Reasonable Compensation?

Q&A-24(a)(2) provides that the amount of parachute payments determined pursuant to Q&A-24(c) (as well as for Q&A-24(b), which applies to accelerated payment of vested amounts) and may not be reduced by reasonable compensation for services rendered after a CIC (as further discussed in Section IV of Part II of this article). This “no-double dipping” rule was included in the Final Regulations, but did not appear in the 1989 or 2002 proposed regulations. While each case should be examined to determine whether the greater benefit would derive from reasonable compensation versus the Q&A-24(c) discount (including, if necessary, pursuant to bifurcation of individual equity grants), as a general matter the larger, dollar-for-dollar benefit derived from the reasonable compensation reduction should be reserved for
payments not otherwise eligible for the Q&A-24(c) discount. In most cases, however, it should be possible to split payments so that part of the payment is subject to the Q&A-24(c) discount and part eligible for reasonable compensation reduction (understanding that the full “dollar-for-dollar” reasonable compensation reduction will not be available using the lost use of the Q&A-24(c) discount).

3. Under Q&A-24(c)(4), How Is The Number of “Full Months” Determined?

The Q&A-24(c) discount formula takes into account the number of “full months” between the accelerated and original vesting date (disregarding any partial months). For example: vesting accelerated to September 2 from November 19 of the CIC year would result in one full month of acceleration (even though there are approximately three months between such dates).  

Special Rule for Vested Compensation for which Payment is accelerated in Connection with a CIC (Q&A-24(b)).

A separate rule applies to accelerated payment of amounts (such as nonqualified elective deferred compensation and SERP payments) that vested before (and independently of) a CIC. The contingent portion of such payment is the amount by which acceleration increases the payment’s present value. If the value of the payment absent acceleration is not reasonably ascertainable (because, for example, the value of the payment may increase or decrease with market returns or the date of payment is unknown), and acceleration does not “significantly” increase the present value of the payment, then there is no additional parachute payment. If the acceleration does significantly increase present value of the payment absent acceleration (because, for example, the payment is a fixed dollar amount), the future value of such payment is treated as equal to the amount of the accelerated payment (so that the time value of money of the accelerated payment, using 120% of the AFR, is the parachute payment). What this means is that if a DI has a vested right to receive $100 in two years, and the payment is accelerated, then the resulting parachute payment equals the “interest” impact of the two-year acceleration. However, if the DI has a vested right to receive 100 shares of common stock in two years and delivery is accelerated, then there is no parachute payment because the value of the payment is not reasonably ascertainable and the acceleration does not significantly increase the payment’s value because the stock would have earned a market return).  

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NOTES:

1Q&A-27.
2Q&A-29.
3Q&A-28; Q&A-28(g), Example 1.
4Under these rules, a vested stock option (or vested stock-settled SAR) generally constitutes ownership of the underlying stock, but an unvested stock option (or cash-settled SAR) does not. Restricted stock is considered to be outstanding when the stock vests or becomes transferable or when a Code Section 83(b) election is filed for such stock.
5Q&A-27(b).
6Q&A-27(b).
7Q&A-46(a). In general, a corporation is a member of an Affiliated Group if more than 80% of voting power and value of the corporation’s shares is directly or indirectly owned by a common corporate parent. An Affiliated Group for this purpose includes foreign corporations under Code Section 1504(b).
8PLR 200422013.
9PLR 200348012, 200110009.
10PLR 200236006.
11PLR 200034013.
12See, for example, PLR 200422013.
14See PLR 9212025 and PLR 9811057.
15The IRS has ruled that a pre-
reorganization board’s approval of a plan of reorganization resulting in a board change is sufficient to satisfy the Q&A-28(a)(2) endorsement requirement for the appointment or election of new directors. See PLR 9747041.

For this purpose, the members of an Affiliated Group are not treated as a single corporation.

Q&A-15(a).

In this regard, the impact of intra-company transfers or accounting charges among a partnership and corporation is not clear, but the nature, frequency and amount of such transfers and charges should be considered.

Q&A-15(b).

See Q&A-15, 17, 18 and 19.

See PLR 200607006.

An individual whose annualized compensation during the DI Determination Period is less than the amount described in Code Section 414(q)(1)(B)(1) ($117,000 for 2014) is not a highly-compensated individual.

Q&A-1(b).

PLR 9822029.

Q&A-3(c) and (d).

Q&A-3(a).

Q&A-3(a).

Q&A-12(b)

Q&A-13(a)

Q&A-13(b). Also see PLR 9119051, ruling that the cash-out of vested stock options does not constitute a payment in the nature of compensation (which occurs upon the vesting of such options).

Q&A-13(a)

PLR 9608020 (regarding the cancellation of an option in exchange for a cash payment equal to the option’s “Black-Scholes” value) and PLR 200032017 (where an additional number of acquirer options received by vested target option holders) can also be read to bolster the view that the extension of the option exercise period should not constitute a parachute payment, although the facts of these rulings are distinguishable from the example given. IRS option valuation guidance in Rev. Proc. 2003-68 and Rev. Proc. 98-34 also support this position, providing that a stock option’s remaining term should be determined as of the vesting date without regard to any termination of employment or other event that could, per the option’s terms and conditions, shorten the option’s life (consistent with Q&A-13(a), which suggests that there should be no differential value attributable to an “extended” post-CIC exercise period, because, at the valuation date (e.g., vesting), the fair value of the option should take into account (at least) the option’s expected term).

Q&A-8.

Q&A-22(a).

Q&A-25.

Q&A-22(b)(ii)(2).

PLR 9202125.

Q&A-22(e), Example 5.

Q&A-22(e), Example 5.

PLR 9202125. In this ruling, however, the IRS left open the possibility that the payments could potentially be characterized as parachute payments in connection with a subsequent CIC of the debtor.

Q&A-22(e), Example 2.

Q&A-25(a) and (b).


Q&A-26. In addition, payments made pursuant to a nondiscriminatory employee benefit program (such as a group term life insurance plan or cafeteria plan), even if entered into or amended during the presumptive period, are not considered to be contingent on the CIC.

Q&A-25(b).

Q&A-24(a)(1).

PLR 9127016.

In this situation, though, any excess parachute payments that may result from bonuses may be eligible for reduction as reasonable compensation for services rendered before the CIC.

It could be argued that, to the extent that the merger agreement includes a “no third party beneficiary” clause, a DI does not actually have a legally-binding pre-CIC right to the bonus and since there is not a legally-enforceable agreement to pay the bonus. See Section III.B.7 below, for additional considerations that may impact this argument.

Q&A-23(a).

DEFRA Bluebook, Example (3) at 202.

Q&A-23, Example 2.

Q&A-31(a).

Q&A-32.

Q&A-31(b)(1).

Based on this convention, payments that are subject to the six-month delay for “specified employees” under Code Section 409A have a reduced value compared to equivalent payments not delayed.

Q&A-24(c).

Q&A-24(b).

Q&A-24(d)(3).

Q&A-24(f), Examples 3 and 4. Note that the IRS also accepted this approach in PLR 9608020.

Q&A-24(f), Example 2.