Golden parachute rules have been eased, but planning is still required to avoid penalties

Although TAMRA made several favorable changes in the treatment of golden parachute payments, taxpayers may still be subject to a substantial liability for them in certain instances. This article discusses the tax and presents strategies and techniques for avoiding it.

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SECTION 280G disallows deductions for payments made by corporations to their key executives in the event of a hostile takeover. In addition, Section 4999 imposes a nondeductible 20% excise tax on the recipients of such payments. The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) made several changes in this area, which are generally favorable to the taxpayer. Although the law remains complex and difficult to avoid with certainty, the use of golden paraehute plans is growing.

Exempt corporations

Under Section 280G(b)(5), corporations eligible to elect S status are exempt from the rules. Under See-tion 1361(b), sueh a corporation may not have (1) more than 35 shareholders, (2) a shareholder that is not an individual (other than an estate or certain trusts), (3) more than one elass of stock, or (4) any nonresident alien shareholders.

The small business corporation exemption was originally unavailable tó otherwise eligible domestic corporations that had disqualifying nonresident alien shareholders. Sinee less favorable treatment was accorded to these corporations, the golden parachute provision was considered discriminatory and was amended by TAMRA to allow the use of the exemption to avoid potential violations of international trade agreements.

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A second exemption covers corporations with stock that is not readily tradable on an established securities market or otherwise if (1) the payment is approved by a separate vote of shareholders who, immediately before the change in ownership or control, hold more than 75% of the voting power of all outstanding stock immediately before the change in control, and (2) there is adequate disclosure to *all* shareholders of all material facts concerning all payments that would otherwise be parachute payments. Shareholders who are disqualified individuals, or who are related to disqualified individuals under the attribution rules of Section 318, are omitted from the base against which the 75% shareholder approval test is applied, if any parachute payments are paid to them. However, if all shareholders are disqualified individuals receiving payments, they are included in the shareholder base.

Prior to TAMRA, a corporation could fail to qualify for the shareholder approval exemption if its stoek included publicly traded nonvoting preferred, even if no common stock of the corporation was publicly traded. On the theory that nonvoting preferred stock is more like debt than equity, TAMRA amended the exemption to exclude stock that (1) is not entitled to vote, (2) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, (3) has redemption and liquidation rights not exceeding the issue price of the stock (exeept for a reasonable redemption or liquidation premium), (4) is not convertible into another class of stock, and (5) has rights that are not adversely affeeted by

the parachute payments. TAMRA requires that Regulations be prescribed concerning the application of the shareholder approval rules to shareholders that are not individuals.

Parachute payments

The provisions of Section 280G and the related excise tax are triggered by a parachute payment, which is a payment in the nature of compensation to or for the benefit of a disqualified individual. In addition, the payment must be contingent on a change in the ownership or effective control of the corporation, or a change in the ownership of a substantial portion of the assets of the corporation. In addition, the total present value of the payments to the individual must equal or exceed three times a base amount (discussed below). If these requirements are met, then the amount that exceeds the base amount (*not* the amount in excess of three times the base amount) is the excess parachute payment which is the amount that is nondeductible and subject to excise tax.

Under Section 280G(b)(6), parachute payments exclude any payment to or from a qualified retirement or qualified annuity plan, or a simplified employee pension plan. In addition, payments to or from such a plan are disregarded in determining whether the threshold for excess parachute payments is exceeded. There is no similar exclusion for other common arrangements, such as nonqualified deferred compensation or stock options. The term also excludes reasonable compenstion for personal services to be rendered on or after the change of control.

Under Section 280G(d)(3), payments are in the nature of compensation whether paid in cash or in property. In an employer-employee context, payments are in the nature of compensation, absent strong evidence to the contrary.

A disqualified individual is an employee or independent contractor who is also an officer, shareholder, or highly compensated individual with respect to the paying corporation. Under Section 280G(c), the highest-paid 1% of the employees of the corporation (or, if fewer, the 250 highest-paid employees), are highly compensated. A personal service corporation or similar entity is treated as an individual for this purpose so that, if an individual performs services for a corporation through a personal service corporation, parachute payments to the personal service corporation are treated as made to the individual.

Affiliated groups. All members of an affiliated group of corporations as defined in Section 1504 are treated as a single corporation. Any person who is an officer or highly compensated individual with respect to any member of the group is treated as an officer or highly compensated individual with respect to the aggregated group. For this purpose, an affiliated group includes tax-exempt corporations, insurance companies, foreign corporations (unless the payment is made to an individual by a foreign corporation acquired by another foreign corporation, and neither is subject to tax in the U.S.), regulated investment companies, and real estate investment trusts.

Change of ownership. A parachute payment must be contingent on a change in the ownership or control of the corporation (or a significant portion of its assets). A payment is contingent if it would not have been made to the disqualified individual if no change in ownership or control had occurred. Even if the change simply determines the time of payment, such as accelerated vesting of deferred compensation, acceleration of the time to exercise stock options, or accelerated payments in cancellation of stock options, that payment is contingent. If the taxpayer's employment is not terminated, either voluntarily or involuntarily, the payment can still be contingent.

A payment made under a contract entered into or amended within one year before a change in ownership or control is presumed to be contingent, absent clear and convincing evidence established to the contrary by the taxpayer. Furthermore, if the Service proves that payments were made in violation of gener-

Exhibit I: Present value of $500,000 over five years

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
1. Annual payment	$100,000	$100,000	$100,000	$100,000	$100,000	$500,000
2. Present value of payment	100,000	90,910	82,640	75,130	68,300	416,980
3. Allocated base amount	23,980	21,800	19,820	18,020	16,380	100,000
4. Excess parachute payment (1 − 3)	$ 76,020	$ 78,200	$ 80,180	$ 81,980	$ 83,620	$400,000

ally enforced securities laws or regulations, they will be parachute payments.

Excess parachute payments

An excess parachute payment exists if the total present value of the parachute payments equals or exceeds three times the base amount. If this threshold is exceeded, the excess parachute payment is the total present value over the base amount (*not* three times the base amount). (This has important planning implications, discussed below.) The base amount is the individual's average annual compensation from the corporation that was includable in income for taxable years in the base period. The base period is the five most recent taxable years ending before the date on which the change in ownership or control occurs or, if less, the period for which the taxpayer performed services for the corporation.

Present value is determined by using a discount rate equal to 120% of the applicable Federal rate, compounded semiannually and determined under Section 1274(d). Under Section 280G(b)(3), if parachute payments are made in installments, the portion of the base amount allocable to any parachute payment is the amount that bears the same ratio to the entire base amount as the present value of the payment bears to the aggregate present value of all payments under the installment contract.

The taxpayer receiving an excess parachute payment is subject to a 20% excise tax, in addition to income taxes. If the excess payment is considered wages, the excise tax must be withheld by the payor-corporation, and the payment is also subject to FICA tax. The special FICA rules for deferred compensation do not apply to excess payments. The excise tax is not deductible by the payee for income tax purposes, and the corporation is not allowed a deduction for the excess parachute payment.

Example. An officer of A Corp. has a base amount of $100,000. He will be paid a $310,000 lump sum by A Corp. in the event of a change in control. Under Section 280G, because the total parachute payments exceed $300,000 (three times the base amount), there is an excess parachute payment of $210,000 ($310,000 less the base amount of $100,000). Assuming a 34%

Exhibit II: Cost of excess parachute payments

	Year 1	*Year 2*	*Year 3*	*Year 4*	*Year 5*	*Total*
1. Annual payment	$100,000	$100,000	$100,000	$100,000	$100,000	$500,000
2. Excess parachute portion	76,020	78,200	80,180	81,980	83,620	400,000
3. Cost of lost corporate deduction (34% of line 2)	25,850	26,590	27,260	27,870	28,430	136,000
4. Excise tax on recipient (20% of line 2)	15,200	15,640	16,040	16,400	16,720	80,000
5. Corporate deduction for base amount (34% of (line 2 – Line 1))	(8,150)	(7,410)	(6,740)	(6,130)	(5,570)	(34,000)
6. Total cost before recipient's income taxes (1+3+4+5)	$132,900	$134,820	$136,560	$138,140	$139,580	$682,000
7. After-tax cost to corporation of paying $100,000 deductible compensation	$66,000	$66,000	$66,000	$66,000	$66,000	$330,000
8. Cost of excess parachute vs. deductible compensation (6÷7)	201%	204%	207%	209%	211%	207%

corporate income tax rate and a 28% personal income tax rate, the after-tax cost to A Corp. is $276,000 ($310,000 × ($100,000 × 34%)). The officer pays $86,800 (28% × $310,000) in income tax and $42,000 (20% × $210,000) in excise tax, and is left with $181,200 after taxes.

If the parachute payment totaled only $290,000, Section 280G would not apply because the parachute payments would be less than three times the base amount. The after-tax cost to A Corp. would be only $191,400 ($290,000 − (34% × $290,000)) and the officer would be left with $208,800 ($290,000 − ($290,000 × 28%)).

To the extent the taxpayer establishes that a parachute payment is reasonable compensation for personal services to be rendered after the date of ownership change, the payment will not be taken into account in determining whether the base amount is exceeded. If the amounts to be paid are not significantly greater than compensation in prior years, or amounts customarily paid to similarly situated employees by the corporation or by comparable employers, this will normally constitute clear and convincing evidence.

The excess parachute payment is also reduced by reasonable compensation for services performed before the date of change in control, after such reasonable compensation is first offset against the base amount.

Example. In the previous example, the taxpayer establishes by clear and convincing evidence that $150,000 of the parachute payment was reasonable compensation for prior services. The excess parachute payment would be reduced to $160,000—the excess parachute payment of $210,000 less $50,000 ($150,000 of reasonable compensation less the base amount of $100,000).

Reasonable compensation for services to be rendered may include payments to a taxpayer as damages for breach of contract. For example, if a corporation fired an employee before the end of an employment contract, the amount the employee collects as damages for lost salary may be treated as reasonable compensation for services to be rendered if:

1. The damages do not exceed the compensation the employee would have received if he had continued to perform services for the employer.

2. The employee demonstrates by clear and convincing evidence that the payments were received because an offer to work was made and rejected.

3. The employee mitigated his damages.

By contrast, damages for failure to make severance payments are not for personal services and are not reasonable compensation.

Effective dates. When it was enacted, Section 280G was effective for payments made under contracts entered into or renewed after 6/14/84. The TAMRA amendments are effective as if enacted in the original statute. Thus, amended returns should be filed if amounts paid before enactment of TAMRA, under an agreement otherwise subject to the golden parachute provisions, are now exempt under the small business corporation, shareholder approval, or qualified plan exemptions or as reasonable compensation.

Avoiding the tax

In a corporate takeover, it may not be feasible to avoid parachute classification by eliminating a definitional element (*e.g.*, "disqualified individual," "compensation," "contingent on a change in ownership"). However, careful advance drafting of compensation agreements and a clear understanding of the rules can help an attorney either avoid the golden parachute rules or identify which party is to bear the burden of the increased taxes.

Since parachute payments must be contingent on a change in ownership or effective control of a corporation, a payment clause stating that a payment is triggered solely by such a change of control or ownership (a single trigger) is subject to Section 280G. Alternatively, the payment can be contingent not only on the change in ownership, but on an event occurring after the change, generally the firing of the executive or an involuntary modification in working conditions (a double trigger). Such clauses may effectively delay the application of the golden parachute rules until the second event occurs, or may avoid them entirely. The second contingency supports an argument that the payment was in the nature of reasonable compensation, because factors other than the change in control triggered the payment. Contracts entered into within one year of a change in control are presumed to be contingent on the change.

Since an excess parachute payment must equal or exceed three times the base amount, many contracts include a formula ensuring that this limit is never reached. For example, if the contract provides that the total present value of a taxpayer's payments cannot exceed 2.99 times the base amount, Section 280G cannot apply. Thus, it is essential to identify the base amount accurately and precisely. Alternatively, the clause could limit the amount of the parachute payment to (1) the maximum amount deductible by the corporation, or (2) the *greater* of (a) 2.99 times the base amount or (b) the amount of reasonable compensation that can be proved by clear and convincing evidence. Because of the unpredictability of the reasonable compensation and deductibility determinations, these modifications provide less certainty and may make it difficult or impossible to quantify the amount actually payable. Using the "2.99 times the base amount" approach, however, can limit the taxpayer to significantly less than his reasonable compensation.

One risk in using such clauses is that payments not originally considered parachute payments could later be determined to be parachutes and included in calculating 2.99 times the base amount; in addition, compensation originally thought reasonable could turn out to be excessive. In many cases, the desired payment will exceed three times the base amount and is in no way compensation for services. These takeover defense-type payments cannot use these kinds of clauses.

In many cases, a disqualified individual will not receive a single payment, but several payments over a period of time. Section 280G measures the aggregate present value of the payments by using a discount rate equal to 120% of the applicable Federal rate, determined under Section 1274(d), compounded semiannually. To avoid Section 280G, the contract may provide that the taxpayer is entitled to receive payments over the shortest period of time that will reduce the present value of the payments to an amount less than three times the base amount.

Example. Assuming a 10% discount rate, a base amount of $100,000, and annual parachute payments of $100,000 to be paid in the year of change and the subsequent four years, Exhibit I on p. 335 shows the present value of the payments. Because the aggregate present value of payments ($416,980) exceeds $300,000 (three times the base amount), there is an excess parachute payment. The base amount is allocated to the stream of payments in the proportion that the present value of each payment bears to the aggregate present value of the payments, as shown in Exhibit I. The excess parachute payment (line 4) for each year is nondeductible by the corporation, and is subject to the 20% excise tax under Section 4999. The taxpayer is also subject to income tax on each $100,000 payment.

Exhibit II on p. 336 indicates that excess parachute payments are more than twice as costly as deductible compensation. Many companies also reimburse executives for the cost of the excise tax by making "grossed-up" parachute payments. In those instances, the cost to the corporation and its shareholders will be higher.

If the taxpayer were to be paid each year the maximum amount that avoids golden parachute classification, the level annual payment to be made over five years is $71,945, using a 10% discount factor:

Year	Annual payment	Present value
1	$71,945	$71,945
2	71,945	65,405
3	71,945	59,455
4	71,945	54,052
5	71,945	49,138
Total	$359,725	$299,995

(For a five-year transaction, the actual 120% applicable Federal rate for February 1989 was 11.36%)

The aggregate present value of the payments ($299,995) is less than $300,000 (three times the base amount), so that the parachute rules are avoided and there is no excess parachute payment. If the taxpayer desired to receive the full $500,000 parachute payment in equal annual payments, Section 280G could only be avoided if the payments were made over a longer time period. At 10%, annual payments of $46,000 for 11 years have a present value of $298,773.

The stream of payments may be less favorable to a taxpayer who desires a substantial payment up front. A balance must be struck between the period of payments and the amounts to be paid, taking into consideration the prevailing discount rate. If the taxpayer can establish that the future payments for services to be rendered after the change in ownership or control of the corporation are reasonable compensation, those payments could be excluded from excess parachute payment consideration. Carefully drafting agreements and specifically defining duties expected to be performed by the taxpayer can aid in the classification of the payments as reasonable compensation, leaving more available for parachute payments. *

Loan with unreasonable rate endangers plan's status

A TAXPAYER'S accrued and vested qualified plan benefits that are used as security for a loan from the plan's trust at an unreasonably low interest rate, results in an impermissible assignment of benefits, according to *Rev. Rul.* 89-14, IRB 1989-6, 6.

The taxpayer participated in a qualified plan that provided that loans from the plan's trust to participants could not exceed the participant's accrued, nonforfeitable benefits. The taxpayer borrowed money from the plan's trust at an unreasonably low interest rate and used the benefits as security for the loan.

In general, under Section 401(a)(13), benefits provided under a qualified plan may not be assigned or alienated. However, Section 4975(d)(1) provides, in effect, that a loan secured by plan benefits may be permissible if it satisfies certain requirements, such as that it bear a reasonable rate of interest. Since the rate of interest on the loan was not reasonable, the use of the taxpayer's accrued nonforfeitable benefit was an impermissible assignment of benefits.

As a result of such actions, the Service can disqualify a plan. In addition, the Department of Labor can force the plan's trustees to reimburse the plan for lost earnings when a loan carries a below-market rate of interest. The Department has issued proposed regulations dealing with unreasonable rates of interest on plan loans. *