Paying the Golden Parachute Excise Tax

By Robert W. Wood • San Francisco

I often wonder how effective excise taxes are. They *should* be effective either in collecting revenue or in thwarting the conduct excise tax statutes are designed to thwart. Perhaps they should be effective in both. Yet, I am told there are at least a couple of federal excise tax statutes that have resulted in no revenue whatsoever being collected. Maybe that means such statutes are super effective in thwarting behavior, so much so that the business community may consider that particular excise tax as a flat prohibition on the conduct.

Apparently that is not the case with the Code Sec. 4999 excise tax on excess parachute payments. The excise tax on excess parachute payments is indeed collected. Unfortunately, it can unwittingly be triggered.

Recently, the Court of Federal Claims held that a transfer of assets from a corporation to a joint venture in which the company was a co-venturer constituted a change in the ownership of a substantial portion of the company's assets. That triggered Code Sec. 280G. That triggered the excise tax.

To make you have just a little more sympathy for this taxpayer, the excess parachute payment in question here was not a cash payment (cash payments, after all, are relatively easy to spot), but involved shares that vested under the terms of a restricted stock agreement. The real fumble in the case was the concept of a change in ownership or control, which crept up on this taxpayer.

Hocus Pocus *Yocum*

In *R.H. Yocum* [FedCl, 2005-2 USTC ¶50,470], Dr. Yocum was the President and CEO of Quantum Chemical Corporation when it became a subsidiary of Millennium Chemical in 1996. A week later, Millennium and Dr. Yocum entered into a restricted stock agreement calling for a transfer of Millennium shares subject to restrictions and a vesting schedule. The agreement prohibited Dr. Yocum from selling, transferring, pledging, hypothecating, assigning or otherwise disposing of the restricted stock, except under some particular conditions.

There was an acceleration of vesting on a "change in control," so Dr. Yocum would receive immediate vesting (and a cessation of restrictions) on all of the unvested shares. This agreement defined a change in control as "either a change in control of the company or a change in control of the employer." The next tax year, Quantum became Millennium Petrochemicals, Inc. ("MPI"), a wholly owned fifth-tier subsidiary of Millennium.

A short time later, Millennium and another company (Lyondell Petrochemical Company) decided to combine some of their operations. They did this by forming a joint venture known as Equistar Chemicals. MPI contributed substantially all of its assets in certain business lines to Equistar. Lyondell contributed $570,000 in cash in exchange for a 57-percent interest in the joint venture, while Millennium contributed $430,000 and received a 43-percent interest. The joint venture was completed in December 1997.

Thereafter, Millennium determined that MPI's contribution of assets to Equistar was a change in control triggering Dr. Yocum's rights under his restricted stock agreement. Accordingly, it treated the stock as vesting on that date. That meant poor Dr. Yocum was deemed to have realized taxable compensation income of $5,733,409. Millennium treated this as an excess parachute payment, withheld $1,146,682 from Dr. Yocum's 1997 wages as a Code Sec. 4999 excise tax on the excess parachute payment and paid it to the IRS.

Not So Fast ...

Dr. Yocum filed his Form 1040 reflecting this excise tax. Then he filed an amended return, claiming a refund of the $1,146,682 tax. Predictably, the IRS denied the refund claim. In the Court of Federal Claims, Dr. Yocum argued that the asset transfer by Millennium to the joint venture did not constitute a change in the ownership of a substantial portion of the assets. Therefore, Yocum argued there was no excise tax on the vesting of his restricted stock.

My Dog Ate My Homework ...

Dr. Yocum had two arguments, one based on legislative history and one that was more organic. The formation of the Equistar partnership, he said, was not the sort of acquisition of assets to which Congress intended the golden parachute provisions to apply. The legislative history was somewhat helpful but did not cover transfers to wholly unrelated parties.

In fact, there was no exception for transfers of property from one corporation to another entity, even if both entities had some overlapping ownership. In 1986, Congress exempted from the Code Sec. 280G rules transfers of assets among members of an affiliated group. Congress went no further than this, which suggested to the court that transfers like Dr. Yocum's had to run the Code Sec. 280G gauntlet.

The court did acknowledge that the legislative history to this provision is replete with references to hostile takeovers. Yet, the court found no indication that hostile takeovers among unrelated parties were Congress's sole focus in enacting the golden parachute rules. To the contrary, the court found that Congress was concerned that golden parachutes triggered by changes in control—whether friendly or not—provided corporate funds to subsidize officers and other highly compensated persons. That, after all, was the reason for the golden parachute provisions.

Second Argument

Dr. Yocum's second argument was that the formation of Equistar did not constitute a change in the ownership of a substantial portion of Millennium's assets under some 1989 proposed regulations. These early proposed regulations had included an overlapping shareholder rule that Dr. Yocum argued evidenced the fact that the golden parachute rule should *not* apply to him. Under this overlapping shareholder rule in the 1989 proposed regulations, Dr. Yocum urged the court to combine the *direct* interest Millennium's shareholders held in Equistar with the *indirect* interest that the so-called overlapping shareholders held in Equistar *via* their 18.2-percent interest in Lyondell. This would mean that Millennium shareholders ended up with more than a 50-percent interest in Equistar (because they held 43 percent directly in Equistar and 10 percent indirectly by virtue of their ownership in Lyondell).

Unfortunately for Dr. Yocum, these proposed regulations were never adopted as final. They were also no longer on the books as proposed, but instead gave way to *new* proposed regulations in 2002. Those new proposed regulations were finalized on August 4, 2003. The final regulations clarified the overlapping shareholder rule, tightening it in a way that left Dr. Yocum out in the cold. [*See* Reg. §1.280G-1, A-29.] The preamble to the final regulations says that this clarification was consistent with the IRS's interpretation of the overlapping shareholder rule in the 1989 proposed regulations.

However, that preamble also states that taxpayers could rely on the 1989 version of the proposed regulations for changes of ownership before January 1, 2004, but could not rely on them for a proposition that contradicted the final regulations on the overlapping shareholder rule. Finding Dr. Yocum's interpretation of the 1989 proposed regulations to be inconsistent with the IRS's clarification of the overlapping rule in the final regulations, the court ruled for the IRS.

Last Word

I'm a big fan of savings clauses in documents. It strikes me as useful insurance to include provisions that ward off the application of some rule or tax. And savings provisions can affect the plain economics, too. In the golden parachute field, it has become standard to include provisions in documents that, notwithstanding the payment structure, in no event will a payment be made that constitutes an excess parachute payment resulting in the dreaded excise tax. Both sides to an agreement have to be comfortable that the agreement still makes sense in the event this savings clause kicks in. But, assuming that business threshold can be met, these provisions work pretty nicely.

Unfortunately, a savings provision of that sort wouldn't address the primary problem in Dr. Yocum's case. The change in ownership or control standard is a more fundamental issue. Still, a savings clause would have prevented this result too, albeit cutting back on stock vesting that was obviously quite valuable here. Yet, once the double whammy of excess parachute payment characterization kicks in, the result can be (depending on the numbers) worse than living with the savings clause!