Bonus Treated As Golden Parachute Payment Even Though Agreement Not Enforceable

by Robert W. Wood • San Francisco

The golden parachute payment rules are important for several reasons. Section 4999(a) imposes a 20% excise tax on "excess parachute payments". Under Section 280G, an excess parachute payment is a payment in the nature of compensation to a "disqualified individual" if the payment is contingent on a change in the ownership or control of the corporation, and the present value of the payment is at least three times the individual's "base amount".

A "disqualified individual" includes any individual who is an employee, independent contractor, or other person specified in regulations who performs personal services for any corporation, and who is an officer, shareholder, or highly compensated individual. The "base amount" is the individual's annualized includable compensation for the base period (generally, the five years endings before the date on which the change in ownership or control occurs).

The excise tax is expensive and nondeductible. It makes the cost of excess parachute payments—golden or otherwise—quite significant. The Seventh Circuit Court of Appeals has now decided a case, *Richard G. Cline, et ux. v. Commissioner*, No. 93-2698 (7th Cir. Feb. 9, 1994), that potentially expands the reach of these parachute payment provisions.

Facts in *Cline*

As President and CEO of Jewel Foods when the company merged with American Stores in 1984, Richard Cline received a severance pay agreement from Jewel under which he and other senior managers who might be terminated on account of the merger would receive an amount equal to three times their annual salary plus a target bonus. After the contracts were executed, the parties discovered that these severance agreements would constitute excess parachute payments that would be subject to nondeductibility by the company and subject to the excise tax. Consequently, they amended the agreement. In exchange for reducing the executive's compensation, Jewel made an oral commitment that American Stores would make a good faith effort to offer the executives employment, for which they would be paid approximately the amounts foregone under the amended severance package.

Mr. Cline's annual salary from Jewel had been $365,000. His 1984 target bonus was $110,000. He received $1,210,000 in severance pay under the amended agreement. He remained with Jewel during the transition period, and received on his resignation his pro rated salary and vacation pay of $109,163, plus a $300,000 bonus. The IRS determined that no part of the $300,000 bonus was reasonable compensation, and therefore assessed a $60,000 excise tax against Mr. Cline. The Tax Court agreed with the IRS. See *Balch v. Commissioner*, 100 T.C. 331 (1993); for prior coverage of Balch and this issue, see Wood, "Additional Compensation Held Excess Parachute Payments in Balch", Vol. 1, No. 11, *M&A Tax Rep't* (June 1993), p. 1.

Seventh Circuit Agrees

The Seventh Circuit Court of Appeals has now agreed with the Tax Court that the amended severance agreement and oral agreement should be considered together as a reiteration of the original severance agreement. In response to the taxpayer's argument that the bonus could not be considered a parachute payment because he had no legal right to demand it, the court referred to the statute for the notion that a

Continued on Page 3

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BONUS TREATED Continued from Page 2
binding contract is not necessary. The provision applies, so said the Circuit Court, to *any* payment that is contingent on a change in ownership or control.

Likewise, the court rejected the taxpayer's argument that his $300,000 bonus was reasonable compensation for services rendered during the transition period. Applying the liberal "not clearly erroneous" standard to the Tax Court's determinations, the Seventh Circuit had to agree with the Tax Court. The Tax Court had noted in its reasonable compensation determination that American Stores had not considered comparable compensation paid to others for similar services when it decided how large a bonus to pay Cline. Furthermore, American Stores' employees were generally not given bonuses.

Watch Out

The decision in *Richard G. Cline, et ux. v. Commissioner*, No. 93-2698 (7th Cir. February 9, 1994), underscores the danger we reported when the Tax Court decided *Balch*. One thing these cases prove, after all, is that there may be a detailed determination of what constitutes reasonable compensation (since asserting the reasonableness of compensation paid is one way of negating parachute payment status). In *Balch*, the Tax Court made a comparison of pre-change daily compensation rates in evaluating the reasonableness of compensation paid after the change in control. Even assuming that a daily rate is not an inappropriate measure of full time service, the fewer the services that are performed, the more problematic to taxpayers the reference to daily rates may become. Indeed, even for an executive who merely remains available to consult after a change of control, but who does very little actual consulting, it may be difficult to determine the appropriate index against which to apply a daily rate. And yet by traditional standards, remaining available to consult can constitute the performance of services.

More fundamentally of course, *Cline* (and *Balch* which preceeded it), raise the awareness of savings clauses in golden parachute agreements to a new level. Jewel Companies no doubt thought it was safe by amending the original parachute agreement to insure that — contractually at least — the payments would not exceed three times the base amount. *Cline* tells us that such caution is ineffective. A savings clause that is part of the golden parachute agreement (specifying that in no event will payments exceed three times the Section 280G base amount, or invoking some other formula to insure that the excess parachute payment definition is not triggered) will presumably still be effective. However, *Cline* suggests that courts may be willing to ask whether there is some informal or extra-contractual arrangement that may undercut the force of such a savings clause. ■