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Golden Parachutes Lose Luster, Section 83 & Reasonable Compensation Restore It

By Robert W. Wood • Wood LLP • San Francisco

The times are a changin', and not only in popular culture. Golden parachutes, once a standard with companies involved in virtually any aspect of deal-making, are not so golden at the moment. In fact, recent events suggest that execs might think that their golden security is going to deploy nicely and carry them lovingly to earth.

It turns out they may fail to unfurl. The defect is not in the packing, but in that most basic of authorities: the shareholders. Recently, shareholders at four companies voted to prevent executives from cashing in on certain stock bonuses in the event their companies are sold.

In short, a kind of grassroots investor perspective suggests that generous pay packages triggered by a merger or sale may have gone too far. Some might argue that this means executives will no longer care or not want to push the envelope. But I'm guessing it will call instead for a little more caution and creativity.

Down With Parachutes

Valero Energy Corp., Gannett Co., Boston Properties Inc. and Dean Foods Co. have all experienced anti-golden parachute votes, as have others. Shareholder votes may or may not be binding, but even if it is legally possible, it is hard to imagine wanting to pay up outsized amounts amid such anti-parachute-pay backlash. Regulators are reportedly demanding better and more timely disclosures too.

These days, shareholders often have votes on how much executives are paid. And one increasingly sensitive pay topic is golden parachute payments. Such "say on pay" votes are not binding.

Still, boards of directors face understandable pressure to take them into account. As a result, the days of seemingly unfettered deals may be gone. Remember these parachuting execs from not long ago?

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Eugene Isenberg, former Nabors Industries Ltd. CEO, was going to get $100 million in cash before he turned it down in the face of mounting criticism; Sanjay Jha of Motorola Mobility Holdings reportedly got $65.7 million when Google took over; Michel Orsinger of Synthes Inc. is said to have received $51.9 million on the Johnson & Johnson deal; and George Lindemann of Southern Union Company reportedly got $53.8 million on the acquisition by Energy Transfer Equity. Of course, that was then.

History Channel

First, a reminder of our past. Golden parachute payments have a longer backstory, but for many tax advisers, the history really started with a crackdown. They came to prominence in 1984 with the enactment of Code Sec. 280G and the corollary excise tax enacted by Code Sec. 4999.

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Proposed Regulations were first released in 1989, and then re-proposed in 2002. They were finalized in 2003. The golden parachute label, along with the reciprocal "golden handcuffs," has featured prominently in many business deals. Notably, these rules apply to private as well as public companies.

Pay As You Go?

A parachute payment is not entirely proscribed, but is not favored either. It incurs two extra tax burdens if it is of a certain size, being deemed "excess." A parachute payment is a payment in the nature of compensation to (or for the benefit of) a disqualified individual that is contingent on a change in the ownership or effective control of the corporation, or in the ownership of a substantial portion of the corporation's assets.

That definition may be a mouthful, but it is fairly clear too. It even involves some common sense. However, it is the size that matters.

If the payment has a present value of at least three times the disqualified individual's base amount (usually the person's average annual compensation for the five years before the change), the payment becomes classified as an excess payment. That makes the payment nondeductible to the extent it exceeds that base amount. [See Code Sec. 280G(b)(1).]

The negative consequences come with a double whammy. Not only is the payment nondeductible to the payer, but it also incurs an excise tax. The excise tax is assessed on the recipient of the excess parachute payment.

The excise tax is 20 percent of the excess parachute payment. It too is expressly made nondeductible. "Disqualified individuals" are defined in a way one would expect.

Generally, they include any employee, independent contractor or other person specified in regulations who performs personal services for a corporation, and who is an officer, shareholder or highly compensated individual. [See Code Sec. 280G(c) and Reg. §1.280G-1, Q&A-15 through Q&A-20.] "Highly compensated" is defined as anyone who is a member of the highest paid one percent of employees or, if less, the highest paid 250 employees. [See Code Sec. 280G(c).]

Who Is Disqualified?

In LTR 200607006, the IRS addressed a fundamental issue: the scope of the "disqualified" person definition. The individual was a director of a corporation. In fact, he was the former chairman of the board of directors.

The company was a bank holding company, and the bank was its subsidiary. There was no question that there was a change of ownership or control (within the meaning of Code Sec. 280G). Furthermore, there was no question that this individual served as chairman of the board of directors for the 12-month period preceding the merger.

However, the interesting point is that he was not a shareholder who owned (directly or indirectly) more than one percent of the stock. What's more, he was not one of the top one-percent highest paid employees or consultants of the company. Notwithstanding all of this, he did get certain benefits by virtue of the change of control.

Indeed, these amounts were significant enough that they exceeded the base amount threshold specified in Code Sec. 280G. The company took the excess amounts (the amount of the benefits that exceeded the director's base amount) and put it in escrow. Conservatively, the company asked the IRS for a ruling on the applicability of the golden parachute payment tax to the escrowed funds.

Sometimes, authority is real, and sometimes it is about perception. A disqualified individual is defined in Code Sec. 280G as an individual who:

- is an employee, independent contractor or other person specified in the regulations who performs personal services for any corporation; and
- is an officer, shareholder or other highly compensated individual.

The question in this ruling was whether this particular director (who, after all, was the former chairman of the board) should be considered an officer. The answer, obvious to even the IRS, was that he was not a shareholder or highly compensated individual. This short-but-sweet ruling refers to the regulations under Code Sec. 280G, which say that all of the facts and circumstances are to be considered.

That means one looks to the source of the person's authority when determining if they are "disqualified." One considers the term for which he or she is elected or appointed. Of course, one evaluates the nature and extent of that person's duties.

You evidently mush this all together and determine whether an individual is an officer. Generally, the term "officer" means an administrative executive who is in regular and continued service. It implies continuity of service and excludes those who are employed only for special or single transactions.

As a result (and without significant explanation), the IRS ruled that this director was not a disqualified individual. He had no administrative executive authority over the company, nor over the board of directors.

That meant all the monies could be released to him from escrow, and no excess parachute payment taint would attach. Of course, private letter rulings do not constitute published authority. At the same time, as a practical matter, they indicate the IRS's position.

The ruling may be helpful in some cases. On the other hand, the "no administrative executive authority" requirement would seem in most cases to be a pretty tough standard to meet.

Everything That Glitters?

Most of the niceties of golden parachute practice involve not merely cash payments but other types of consideration. In fact, cash is relatively straightforward. Other consideration is often confusing.

The law is clear that payments may come in a variety of forms. The restricted property rules of Code Sec. 83 are very much in the mix. For example, the vesting of options is treated as a payment in the nature of compensation. [See Reg. §1.280G-1, Q&A-13.]

Over the years, a considerable amount of attention has also been paid to triggering events. In general, a payment will be treated as contingent on an ownership or control change if it in fact would not have been made had no change occurred. This is so even if the payment is expressly conditioned upon another nonacquisition event. [See Reg. §1.280G-1, Q&A-22(a).]

You may think you have mastered these rules and that you can spot a parachute payment when you see one. Nevertheless, Chief Counsel

Advice 200923031 suggests that there are subtleties here. More pejoratively, there are traps for the unwary.

CCA 200923031 examines consideration in an acquisition. More discusses, it examines the extent to which the cancellation of nonlapse restrictions under Code Sec. 83, and/or the acceleration of vesting of unvested stock rights constitute parachute payments. Short answer? They do.

Tax Gross-Ups

Not surprisingly, executives love tax gross-ups. That makes sense, given that they could be facing extra taxes. And the more generally applicable the tax gross-up, the better.

Congress tried to curb excessive golden parachutes by enacting extra taxes in 1984, including a dual-pronged excise tax and the additional sanction of nondeductibility. Tax gross-ups seemed to be one answer, and many companies responded by reimbursing the departing executives with a tax gross-up on the payout.

That made the situation even more controversial. Adding to the mess and the magnitude of the issue is the fact that much of the consideration typically does not come in cash. Much of the typical payday comes in the form of accelerated vesting of options or the release of restrictions on otherwise restricted stock.

Perhaps tax gross-ups are bargained for and fair. Perhaps they are a bad thing, making shareholders angry and affecting shareholder votes. At a minimum, they are obvious, and to that extent undesirable from a public relations point of view.

Fun with Numbers

It does not seem to be an exaggeration to say that the base amount used to determine (after a multiplier of three) what goes in the "excess" category can be manipulated. After all, it can be increased by exercising options. It can be expanded by electing not to defer amounts under a nonqualified deferred compensation plan.

It can even be enlarged by paying bonuses during the five-year period ending before the year of the change in control. These are fundamental points. In short, the base amount is not a static number.

The other side of the equation is also not static. The value of payments can be reduced, for example, by cashing out options on a change in control. That could limit the value to the cash-out amount (as opposed to a higher value associated with an unexercised option that could be exercised after a change in control).

Packing the Parachute

Parachute payments are those for which the company is allowed no deduction because of Code Sec. 280G. Not only that, but the recipient incurs a whopping 20-percent excise tax under Code Sec. 4999, in addition to normal payroll withholding and income tax. The combination of these two provisions is meant to be draconian.

In determining whether a payment constitutes a parachute payment, restricted stock and stock options can really jam up the works. This is especially true with restricted stock which has been the subject of a Code Sec. 83(b) election.

One of the most fundamental concerns is whether one has had the requisite change of control triggering the application of these rules. In assessing the measurement of a change in control, Revenue Ruling 2005-39, IRB 2005-27, 1, highlights a fundamental inconsistency. In effect, one disregards Code Sec. 83(b) elections in determining when golden parachute payments are deemed received.

On the other hand, one is to respect those very same Code Sec. 83(b) elections in determining what stock is outstanding when measuring a golden parachute change of control. This can matter more than you might think.

Rev. Rul. 2005-39

In Rev. Rul. 2005-39, Sun Corp. and Moon Corp. both had readily tradable stock and merged on February 20, 2005, to form Twilight Corp. Other than somewhat different positions regarding restricted employee stock, this was a merger of equals. The vested shareholders of Sun and Moon each received 50 percent of the stock of Twilight.

However, Sun and Moon both had employee stock plans for which none of the stock had been vested as of the merger date. Even so, as not infrequently occurs, all employees had made Code Sec. 83(b) elections. The stock held by the Sun employees had a market value of $3X, and the stock held by the Moon employees had a market value of $2X.

Interestingly, if the unvested employee stock was not treated as outstanding under these facts, there would be no change in ownership under Code Sec. 280G. Axiomatically, there would therefore be no triggering of the golden parachute rules. After all, the shareholders of Sun and Moon each owned exactly 50 percent of the stock of Twilight.

Nevertheless, what if the holders of the unvested employee stock were treated as Sun and Moon shareholders, respectively? They could be so treated, one could argue, because of the Code Sec. 83(b) elections. In that event, the Sun shareholders would by definition have acquired more than 50 percent of Twilight and hence of Moon.

Thus, as to Moon, there would be a change of ownership under Code Sec. 280G. This may start to sound like Code Sec. 382 analysis. Keep in mind, however, that an ownership change occurs under Code Sec. 280G on the date that any one person (or more than one person acting as a group) acquires ownership of stock of a corporation that, together with stock already held by that person or group, possesses more than 50 percent of the total fair market value or total voting power of the stock of the corporation. Code Sec. 318 rules apply in determining ownership by attribution.

Code Sec. 83(b) Election

Code Sec. 83(a) postpones income recognition events on transfers of property subject to restrictions. The corollary is that an employer who transfers the property receives no deduction. It is also postponed until the time it can be included in the income of the employee.

Code Sec. 83(b), on the other hand, allows the taxpayer who is receiving this stock or other restricted property to elect to include it in income on transfer. If the taxpayer makes a Code Sec. 83(b) election, the income is measured by the excess, if any, of the fair market value of what is received (measured regardless of restrictions or risks of forfeiture) over the purchase price. Especially when this excess is close to zero, an election can be a good tax play for the employee.

A zero excess amount (where the price paid for the restricted stock equals fair market value) will mean that despite the election, the employee has no income tax consequence on the transfer. Making a Code Sec. 83(b) election can be smart where the executive is paying market value. The result is a nice potential upside.

In fact, you can look at it as a tax-free conversion. The restricted property and any appreciation morphs from ordinary income into capital gain property.

Sections 280G and 83(b) Go Dancing

In some ways, it is downright strange that Code Sec. 280G makes no reference to Code Sec. 83(b). Code Sec. 83 long predates Code Sec. 280G. Therefore, one might think that the latter provision would invoke some explicit interaction.

Code Sec. 280G allows the Treasury Secretary the authority to prescribe regulations, and that they did. The Code Sec. 280G regulations take the position that an election made by a disqualified individual under Code Sec. 83(b) will be disregarded for purposes of Code Sec. 280G in determining the amount and timing of the receipt of payments in the nature of compensation. [See Reg. §1.280G-1, Q&A-12(b).]

This seems to take Code Sec. 280G a step further, covering situations in which the transferor is not entitled to a deduction in any event. After all, Code Sec. 280G is meant to deny deductions for excess parachute payments. That purpose does not seem to be served here.

Rev. Rul. 2005-39 does conclude that stock that was subject to the Code Sec. 83(b) election must be considered as outstanding stock in measuring the change in control. Rev. Rul. 2005-39 seeks to resolve this apparent contradiction. It states that an expansive rule needs to be implemented to determine whether a change in ownership or control has occurred.

It cites Reg. §1.280G-1, Q&A-27(c) for this purpose. The ruling says that an employee should be considered the owner of unvested shares of restricted stock for which an election has been made under Code Sec. 83(b). Why?

Because the regulations under Code Sec. 83(b) treat stock transferred to an employee in connection with the performance of services as substantially vested when the employee makes that election. Plainly, the employee is also considered the owner of the stock.

On the other hand, restricted stock with respect to which an election under Code Sec. 83(b) has not been made is not considered outstanding for purposes of determining whether a change in ownership or control has occurred.

Reasonable Compensation?

Keep in mind that payments that are considered reasonable compensation for services rendered after a change in control are ignored in running the excess parachute payment tab. Notably, a payment for a covenant not to compete is to be treated as the equivalent of providing services after a change in control. [See Reg. §1.280G-1, Q&A-42(b), (d), Example 3.]

That means a payment to comply with a covenant not to compete can fall wholly outside of the daunting excess parachute payment formula. This is hardly a panacea, and there are some nuances to be observed. Still, it is worth examining whether at least some of the payments can be purified by requiring services.

What do we mean by reasonable compensation for services to be rendered after a change in control? It would surely include the normal showing up and doing work. But it could include some other more unusual payments as well. For example, it might include payments received by an executive for breach of contract because of an involuntary termination without cause. [Reg. §1.280G-1, Q&A-42(c).]

Like so much of the rest of reasonable compensation lore, whether payments to a disqualified individual are actually reasonable compensation for purposes of Code Sec. 280G will be determined on the basis of all facts and circumstances. [*See* Reg. §280G-1, Q&A-40.] Relevant factors include the nature of the services rendered, the disqualified person's historic compensation for those services and the compensation of individuals performing comparable services in the absence of a change in ownership or control.

For past services, a showing that payments are reasonable under the standards of Code Sec. 162 will be treated as evidence that they are reasonable compensation for purposes of Code Sec. 280G. [*See* Reg. §1.280G-1, Q&A-43.] For future services (to be rendered on or after the date of the change in control or ownership), clear and convincing evidence that the payments represent reasonable compensation will generally not exist if the disqualified individual does not actually perform the services at that later date. [*See* Reg. §1.280G-1, Q&A-42(a).] That means following through and keeping records are important.

Independent Investor Test

One of the more objective factors focuses upon what an independent investor in the company would have expected and received. Some courts have determined that corporate profits (after deduction for salaries to shareholder employees) should be considered in determining whether compensation paid is reasonable. One of the best-known cases is *Elliotts, Inc.*, CA-9,86-2 USTC ¶9610, 716 F2d 1241 (1983).

There, the court stated that if the "company's earnings on equity remain at a level that would satisfy an independent investor, there is a strong indication that management is providing compensable services and the profits are not being siphoned out of the company disguised as salary." [*Id.*, at 1247.]

Applying the independent investor test is essentially a matter of considering the total return to the investor. One should include dividends, stock appreciation and corporate earnings. That means there can be some flexibility. [*See Home Interiors & Gifts, Inc.*, 73 TC 1142, Dec. 36,842 (1980).] The IRS takes the position that a low rate of return on invested capital may support an inference that payments to shareholders constitute a distribution of profits.

Of course, this is only an inference. The IRS has generally been required to show that this low rate of return during the years in question was caused by unreasonable compensation and not other factors, such as fluctuating business cycles. [For example, *see Bringwald, Inc.*, Ct Cls, 64-2 USTC ¶9638, 334 F2d 639 (1964).]

In *LabelGraphics, Inc.*, CA-9, 2000-2 USTC ¶50,648, 221 F3d 1091 (2000), a corporation producing pressure-sensitive labels and selling to high-tech companies deducted $878,913 in compensation paid to the president and sole shareholder. The IRS disallowed $633,313. It was unreasonable by any measure, said the IRS.

Defending the deductions, the company showed that the president was the heart of the company. He set corporate policy and monitored quality control, compliance and even external relationships. He also developed a new product.

The Tax Court upheld $406,000 of the $878,900 paid, concluding that the balance was not reasonable. The court was struck by the fact that the $722,900 paid to the president was nearly three times the amount of his largest prior bonus. Yet LabelGraphics failed to prove that any of this was attributable to prior inadequate compensation.

Regarding the independent investor standard, the Tax Court noted that given the large bonus, LabelGraphics suffered a loss, with a negative 6.19-percent return on equity. An independent investor would not be satisfied, the court said, especially when the bonus equaled 45 percent of the investor's equity. The Ninth Circuit affirmed, finding that the Tax Court did not err in determining what was reasonable.

The Proof's in the Audit

Practitioners might agree with the IRS's position in Rev. Rul. 2005-39. On the other hand, they might find it inconsistent with the regulations. Yet it is not hard to understand why the IRS would like such a rule.

Moreover, when the IRS later released an MSSP on golden parachute audit techniques, the central issues were clear. [See Tax Analysts Doc. No. 2005-7773, 2005 TNT 77-25, released Apr. 13, 2005.] This manual includes reporting requirements for golden parachute payments and gives nine steps for Revenue Agents to follow in conducting a parachute examination:

1. Determine whether there has been a change in ownership or control.
2. Establish who are disqualified individuals.
3. Determine each disqualified individual's base amount and multiply it by three to establish the safe-harbor amount.
4. Determine what payments in the nature of compensation were made to each disqualified individual that were contingent on the change in ownership or control.
5. Determine whether any of the payments that were contingent on the change of ownership or control because of acceleration can have the contingent portion reduced under the regulations.
6. Reduce each parachute payment by whatever portion the taxpayer establishes with "clear and convincing evidence" is reasonable compensation for services to be rendered on or after the change of ownership or control.
7. Determine the present value of the contingent payments, as reduced by Steps 5 and 6, to determine whether the aggregate present value of all the payments equals or exceeds the safe-harbor amount (Step 3).
8. If the present value of the contingent payment exceeds the safe-harbor amount (Step 7), determine whether the taxpayer has shown with clear and convincing evidence that a portion of the payment is reasonable compensation for services rendered before the change in ownership or control.
9. Calculate the excess parachute payment by subtracting from each parachute payment the greater of the allocable base amount or the reasonable compensation of Step 8.

Safe Landings

The golden parachute rules are hardly new. In an era in which tax rules seem to change quite frequently, they have been around for decades. However, they can still be a kind of "gotcha." This is certainly true for clients, and also for practitioners who are not used to encountering them.

Such gotchas can be unnerving and expensive. If you do have a golden parachute payment problem, the consequences of ignoring the issue can be pretty serious. It can include disallowing the deduction for the payment under Code Sec. 280G and incurring the 20-percent excise tax under Code Sec. 4999. People will be unhappy.

Golden parachute payments and the mechanical aspects of their computation can be ripe subjects for examination. The IRS must think so too. The presence of the MSSP guidelines means that golden parachute payments may be even more likely to be examined.