When Golden Parachutes Rip

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Executive compensation remains a hotly contested topic in the tax law. When Congress hopes to rein in what they perceive to be oversized salaries or bonuses, they often turn to the tax code. A good example is the now infamous Code Sec. 409A, added to the Code in 2004 in response to abuses of executive compensation plans by companies such as Enron. [For prior Code Sec. 409A coverage, *see* Karachale, *The 409A Hit Parade Continues*, M&A TAX REP., Feb. 2010, at 1; Wood, *Fear & Loathing in Code Sec. 409A*, M&A TAX REP., Dec. 2008, at 3.]

Even in all-cash mergers, the stakes for executives can be high. Often the target's executives will have stock and unvested options. That can mean tiptoeing through a veritable minefield of tax issues.

For example, it's quite common for the executives of a target to have their unvested options accelerated by the deal. In effect, they may be treated as owning the shares of stock subject to those options, thus giving them a larger piece of the consideration on sale. But the inevitable dichotomy between sales proceeds and services may rear its head.

In one sense, after all, some of the consideration could be considered a payment for services and/or a payment contingent on a change in ownership or control. There may be some concern about the ordinary versus capital rate differential. However, it would be a true double whammy for a payment that is denominated as one for equity (and thus nominally capital) to be recharacterized and treated as compensation, and simultaneously viewed as an excess parachute payment.

Avoiding Excess

An excess parachute payment is something to be avoided. As we've noted in the past, savings clauses for excess parachute payments and unreasonable compensation are now standard operating procedure for many employment contracts. [*See* Wood, *Golden Parachute Guidance*, M&A TAX REP., Aug. 2009, at 5; Wood, *Funny Money: Deducting Reasonable Compensation*, M&A TAX REP., Apr. 2009, at 5.] After all, the excess parachute designation carries double—or maybe even triple—trouble.

First, the executive is subject to the 20-percent excise tax imposed by Code Sec. 4999 on the excess parachute payment. Second, the payor can't deduct it. Our third concern is not far-fetched: Could the executive be subject to a 20-percent income tax plus interest imposed by Code Sec. 409A(a)(1)(B) on deferred compensation? Any one of these is onerous, but—taken together—they could cause a taxpayer to hoist the white flag.

Let's leave the Code Sec. 409A issue aside and focus on the rules and new guidance related to golden parachutes.

Golden Guidance

Code Sec. 4999(a) imposes a tax equal to 20 percent of an excess parachute payment. An excess parachute payment is an amount equal to the excess of any "parachute payment" over the portion of the "base amount" allocated to such payment. [*See* Code Sec. 280G(b)(1)].

Generally, "parachute payments" are payments in the nature of compensation to highly compensated workers or shareholders ("Disqualified Individuals") of a corporation in the following circumstances:

1. Such payments are contingent on a change in the ownership of a substantial portion of the assets of the corporation.
2. The aggregate present value of the payments that are contingent on such change equals or exceeds three times the base amount. [*See* Code Sec. 280G(b)(2)(A).]

The "base amount" represents the average annual compensation of Disqualified Individuals for services performed for the corporation with respect to which the change in ownership or control occurs. [*See* Reg. §1.280G-1 Q/A 34.]

Subject to a reduction for reasonable compensation for services actually rendered before the change in control, the excess parachute payment is the difference between the parachute payment (*i.e.,* the amount in excess of three times the base amount) and the base amount itself. This excess may be subject to the 20-percent excise tax of Code Sec. 4999.

Parachutes Away

Fortunately, CCA 200923031 (Feb. 2, 2009), provides guidance making the artillery fire of Code Sec. 280G a little less deafening. We previously noted this piece of administrative advice [*see* Wood, *Golden Parachute Guidance*, M&A TAX REP., Aug. 2009, at 5), but its importance bears further review.

In CCA 200923031, a privately held corporation maintained a plan that provided for the granting of some stock rights to designated executives of the corporation. The stock rights included options to buy shares of the corporation's common stock at book value.

The corporation wanted to enter into a transaction that would result in a change in ownership of a substantial portion of the corporation's assets. As a result of the transaction, the book value restriction under the plan would be canceled and corporate stockholders would be entitled to the fair market value of their shares of common stock at the close of the transaction. Some unvested stock rights also would become fully vested.

In response to the corporation's request, the IRS ruled that the removal of the book value restriction on the common stock was a noncompensatory cancellation of a nonlapse restriction under Code Sec. 83. Thus, the IRS ruled that no part of the consideration payable for the vested common stock would constitute a parachute payment under Code Sec. 280G. Furthermore, the IRS ruled that accelerating the vesting of the unvested stock rights in connection with the transaction would cause the resulting compensation to be a parachute payment under CodeSec. 280G.

Common Stock Avoids the Hatchet

Interestingly—and helpful to most taxpayers—the CCA appears to clarify that consideration payable with respect to vested common stock will *not* constitute a parachute payment. That makes sense. The IRS does not cite to particular authority for this proposition. Nevertheless, the rule appears to conform to Reg. §1.280G-1, Q/A 13(b).

That Q/A provides that any money or other property transferred to the Disqualified Individual upon the exercise of an option after the time the option vests is *not* treated as a payment in the nature of compensation to the Disqualified Individual. The same is true for any consideration in the sale or other disposition of the option. This section of the CCA represents good news. After all, it seems to indicate that even if the IRS deems the payments *compensatory* for purposes of capital gain analysis, they may not constitute parachute payments for purposes of the 20-percent excise tax.

Options and Opportunities for the IRS

Regarding the executives' unvested stock options, the CCA provides more cannon fodder for the IRS. According to the CCA, Reg. §1.280G-1, Q/A 13(a) provides that an option (including incentive stock options) is treated as property that is transferred when the option becomes substantially vested within the meaning of Reg. §1.83-3(b) and (j). Thus, for purposes of Code Sec. 280G and 4999, the vesting of an option is treated as a payment in the nature of compensation.

That means if the executives have unvested options that vest pursuant to the change of control (so they can be exercised and the underlying stock sold), a portion of the value of the options will be compensatory. How much? That, it turns out, is not so easy to say.

The CCA has to navigate its way through the complex rules of Reg. §1.280G-1, Q/A 24 including the calculation of compensation due to a change of control. Fair warning: Wading through these regulations is a bit like fighting trench warfare on the Western Front—in the rain.

Nevertheless, the general caution is simple. Some portion of the unvested options that are accelerated at the time of the change of control is likely to be viewed as compensation. That means they may be subject to the 20-percent excise tax of Code Sec. 4999.

Conclusion

The potential penalties attaching to executive compensation deals gone bad are many. Indeed, one need only look to the Obama administration's latest proposed tax on bank bonuses to find another arena where there may be dogfights in the executive compensation skies. But at least in the context of golden parachutes, CCA 200923031 provides largely helpful guidance.