



Revisiting Golden Parachutes

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This article is part of a just-published December 2003 update to the four-volume treatise *Mergers, Acquisitions, and Buyouts* by Martin D. Ginsburg and Jack S. Levin, of which Donald E. Rocab is a volume coauthor (cited in this report as *Ginsburg & Levin Treatise*).

In this article, the authors review the complex penalty tax rules governing golden parachute payments. Recently finalized Treasury regulations, generally effective January 1, 2004, have made numerous changes (some clear and some subject to debate) to the rules governing payments by a corporation to an executive contingent on a change in the corporation's ownership or control. The authors give an in-depth explanation of the tax treatment of golden parachute payments, analyze how the newly issued regulations alter the executive compensation landscape, and provide numerous examples to illustrate the rules' application.

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Table of Contents

I. Introduction	237
II. Penalties on Excess Parachute Payment	238
III. 'Change in Ownership or Control' Defined	239
IV. 'Contingent 'on Change Defined	241
A. In General	241
B. Payment Resulting From Change	241
C. Closely Associated Payment	241
D. Agreement Within One Year Before Change	242
E. Agreement After Change	242
F. Acceleration of Vested Benefits	244
G. Accelerated Vesting of Benefit Previously Subject Only to Time Vesting	245
H. Agreement Violating Securities Laws ...	249
I. Employment Termination Not Required ..	249

V. Reduction for Reasonable Compensation ..	250
A. Compensation for Future Services	250
B. Compensation for Past Services	250
C. Reasonable Comp Determination	250
VI. Additional Definitions and Rules	251
A. Identity of Payor	251
B. Covered Executive	251
C. Base Amount	252
D. Deferred Payment	252
E. Payment: Options and SRFs	253
F. Future Uncertain Parachute Payment ...	253
G. Withholding	254
VII. Private Companies and Friendly Acquisitions	254
A. Small or Privately Held Company	254
B. Friendly Acquisition	260
VIII. Economic Effect of Section 280G	260
IX. Conclusion	261

I. Introduction

When a purchasing entity (P) acquires ownership or control of a target corporation (T), the principal beneficiaries are T's shareholders. However, in a friendly acquisition — as well as a hostile takeover — T's executives also may receive substantial benefits. Under long-standing agreements between T and its executives, or new agreements entered into in anticipation of the change in T's control, (1) payments to T's executives may be triggered, (2) T stock options may become exercisable, (3) restricted T stock may vest, and (4) T's executives may be entitled to severance payments if they lose their jobs after the change. Even if T's executives are not entitled to benefits under preexisting or new agreements with T, T or P may make special payments to T's executives or enter into other advantageous agreements with them.

Troubled, it appears, that excessive benefits heaped on T's executives might reduce P's acquisition payments to T's shareholders and eager to protect T's shareholders — who rarely if ever sought that protection — from perceived executive predation, Congress 20 years ago inflicted on an otherwise near-perfect Internal Revenue Code section 280G and section 4999, the golden parachute penalty tax provisions. In this

article, we address the current state of that 1984 misfortune because Treasury, celebrating the 20th anniversary of enactment, has brought forth voluminous and complex final regulations generally effective January 1, 2004.¹

II. Penalties on Excess Parachute Payment

Section 280G disallows T's deduction for, and section 4999 imposes a 20 percent nondeductible excise tax on an executive receiving, an "excess parachute payment."

Congress 20 years ago inflicted on an otherwise near-perfect Internal Revenue Code section 280G and section 4999, the golden parachute penalty tax provisions.

In general, an excess parachute payment is any "parachute payment" described in (1) and (2) below, less the subtraction described in (3) below, except to the extent the payment satisfies one of the two exceptions (SCo-eligible-company or nonpublic company with more than 75 percent shareholder vote after adequate disclosure) described in (1)(d)(iii) below.

(1) An executive's — or any other person's — parachute payment is any payment (or payments) satisfying *all* of the following requirements:

(a) a payment "in the nature of compensation" (in cash or property, treating a stock option as property *and* a covenant not to compete payment as in the nature of compensation),²

(b) paid to an executive or other person who is a "disqualified individual" (as described in part VI.B of this article),

(c) which is contingent or presumed contingent (as discussed in part IV) on a change "in [T's] ownership or effective control" or in ownership of "a substantial portion" of T's assets (a change),

(d) after *reduction* by any portion of the payment:

(i) shown by "clear and convincing evidence" to be reasonable compensation

for services to be rendered by the executive *after* the change, or

(ii) to or from a qualified ERISA plan, or
(iii) covered by exceptions where T is (A) an SCo-eligible company or (B) a nonpublic company and the payment garners more than 75 percent shareholder approval after adequate disclosure (as discussed in part VII.A).

(2) The amount described in (1) constitutes a parachute payment only if the payments described in (1) (after reduction by the amounts described in (1)(d)) have a present value as of the change date equal to or greater than three times the executive's average annual compensation from T (and any related or predecessor corporation) includible in his income for the five years ending before the change (the executive's base amount).

(3) An excess parachute payment is the excess of the amount described in (1) (so long as the threshold described in (2) is met) over the *greater of*:

(a) the executive's base amount or

(b) the amount of the payment shown by clear and convincing evidence to be reasonable compensation for services rendered by the executive *before* the change.³

Example 1

Executive A had \$100,000 per year average taxable compensation from T in year 1 through year 5. In connection with T's year 6 ownership change, A receives a \$299,000 parachute payment from T (as described in (1) above). The golden parachute provisions do not apply because \$299,000 is less than three times A's \$100,000 base amount.

Example 2

Same as Example 1, except that A receives a \$300,000 parachute payment. Because the parachute payment (\$300,000) is equal to or more than three times A's \$100,000 base amount, the parachute payment (\$300,000) less one times A's base amount (\$100,000) is an excess parachute payment (\$200,000) (assuming that the amount set forth in (3)(b) does not exceed the amount set forth in (3)(a)). The golden parachute provisions apply to the \$200,000 excess parachute payment, that is, \$200,000 is nondeductible by T, and A pays a 20 percent nondeductible excise tax on the \$200,000 (increasing A's marginal tax rate on such amount by 20 percentage points).

See *Ginsburg and Levin Treatise* para. 1503.1.1 for a discussion of other limitations on T's deduction for compensation paid to executives.

¹The August 2003 final regulations apply to a payment contingent on a post-December 31, 2003, change of control. See reg. section 1.280G-1 Q&A 48. The preamble to the final regulations states that, for a payment contingent on a pre-January 1, 2004, change of control, taxpayers may rely on either the 1989 or 2002 proposed regulations. See also 2002 prop. reg. section 1.280G-1 Q&A 48.

²Staff of Joint Comm. on Taxation, 98th Cong., 2d Sess., *Tax Reform Act of 1984: General Explanation of the Revenue Provisions* 199, 200 (Comm. Print 1984) (1984 Blue Book); reg. section 1.280G-1 Q&A 11 through 13. See also 1989 and 2002 prop. reg. section 1.280G-1 Q&A 11 through 13.

³Section 280G(b).

III. 'Change in Ownership or Control' Defined

For a payment to be a parachute payment, the payment must be (or must be presumed to be) contingent on (1) a change in T's "ownership," (2) a change in T's "effective control," or (3) a change "in the ownership of a substantial portion of [T's] assets."

The regulations define a change in T's *ownership* as occurring on the date that any person (or persons acting as a group) acquires ownership of stock that, together with stock already owned by the person or group, possesses more than 50 percent of T's total value or voting power.⁴

The regulations state that a change in T's *effective control* is *presumed* to occur on the date that either:

- (1) any person (or persons acting as a group) acquires during a 12-month period stock that possesses 20 percent or more of T's voting power or
- (2) a majority of the members of T's board of directors is replaced during a 12-month period by persons not endorsed by a majority of the previous board (including a change in directors pursuant to a proxy contest). This presumption may be rebutted by demonstrating that that event has not transferred the power to control T's management and policies from any one person or group to another.⁵

In the absence of either of those two events, a change in effective control is *presumed* not to have occurred.⁶

Under the regulations, a change in ownership of a *substantial portion of T's assets* occurs on the date a person (or persons acting as a group) acquires, within a 12-month period, assets having a gross fair value (FV) without regard to liabilities (gross assets) equal to one-third or more of T's gross assets.⁷ For this purpose, the following transfers are disregarded: any transfer of T's assets (1) to a shareholder in exchange for or with respect to his T stock, or (2) to an entity 50 percent or more of the total value or voting power of which is owned by T or by persons who own 50 percent or more of T's stock (by vote or value), or (3) to a person (or

persons acting as a group) who owns 50 percent or more of T's stock (by vote or value).⁸

In applying these rules:

(1) Persons are not treated as part of a group merely because they purchase stock at the same time or as part of a single public offering, but are treated as part of a group if they are owners of an entity that enters into a merger, stock acquisition, or similar transaction with T. Under the regulations, a person who owns stock in T and P is considered to be acting as a group with respect to other P shareholders only to the extent of that person's ownership of P stock before the transaction, and not with respect to that person's T ownership.⁹

Example 3

T merges tax free into P. In the merger, T's shareholders (none of whom previously owned P stock) receive less than 20 percent of P's stock.

The merger results in a change in ownership of a substantial portion of T's assets, but not a change in P's ownership or control.

A 2002 IRS private letter ruling concluded that T's bankruptcy reorganization did not constitute a change in T's ownership or effective control, notwithstanding that T's creditors acquired most of T's stock in the reorganization (with one creditor receiving more than 20 percent of T's stock) and entered into a shareholders agreement regarding T's ownership and management, implicitly on the ground that T's creditors would not be treated as a group, even though they entered into a shareholders agreement.¹⁰ The IRS's rationale for this taxpayer-favorable determination was that "[t]he passive receipt of stock by a creditor under a bankruptcy plan of reorganization is essentially involuntary in that the creditors . . . typically would prefer that the debt be paid in cash rather than stock of the debtor. The fact that [the] plan of reorganization provides for the creditors to receive stock instead of cash is a function of [bankrupt T's] financial resources . . . and is not indicative of any intention on the part of the creditors, either singly or acting as a group, to acquire control of the debtor."

(2) A "change in effective control [does not] occur in any transaction in which either of the two corporations involved in the transaction has a change in ownership or control."¹¹ The regulatory preamble describes this provision as adoption of "the 'one change' rule that historically has been applied by the IRS . . . [so] that if a corporation undergoes a change in ownership or control . . . , the other corporation in-

⁴Reg. section 1.280G-1 Q&A 27. See also 1989 and 2002 prop. reg. section 1.280G-1 Q&A 27.

⁵LTR 200034013, Doc 2000-22063 (5 original pages), 2000 TNT 167-18, relied on the following factors to rebut the presumption of a change in effective control when P purchased slightly more than 20 percent of the stock of public T: (1) T's founders and management continued to hold a substantial stock ownership position in T, (2) P's percentage stock ownership in T was expected to fall below 20 percent relatively soon as a result of the exercise of management options, (3) none of P's shareholders or executives held management positions with T, and (4) P's acquisition of T stock was consistent with that of an institutional investor.

⁶Reg. section 1.280G-1 Q&A 28. See also 1989 and 2002 prop. reg. section 1.280G-1 Q&A 28.

⁷Reg. section 1.280G-1 Q&A 29. See also 1989 and 2002 prop. reg. section 1.280G-1 Q&A 29.

⁸Reg. section 1.280G-1 Q&A 29. See also 1989 and 2002 prop. reg. section 1.280G-1 Q&A 29.

⁹Reg. section 1.280G-1 Q&A 27(b) and (d), example (4), -1 Q&A 28(e), -1 Q&A 29(c). See also 2002 prop. reg. section 1.280G-1 Q&A 27(b) and (d), example (4), -1 Q&A 28(d), -1 Q&A 29(d).

¹⁰LTR 200236006, Doc 2002-20386 (6 original pages), 2002 TNT 174-30.

¹¹Reg. section 1.280G-1 Q&A 28(c).

involved in the transaction does not undergo a change in ownership or control.”¹² However, earlier private rulings that reached a “one change” conclusion were based on representations that T’s stock was widely held and, after the merger, the former T shareholders did not act in a concerted way to control P’s management and policies.¹³

Example 4

Same as Example 3, except that in the merger, T’s shareholders receive 40 percent of P’s stock.

The merger results in a change in ownership of a substantial portion of T’s assets. Also, under the general rule described above, the merger would be presumed to result in a change in P’s effective control. However, under the final regulations’ “one change” rule, because T has undergone a change in ownership, no change in P’s ownership is treated as occurring.

Example 5

Same as Example 3, except that in the merger, T’s shareholders receive 51 percent of P’s stock.

The merger does *not* result in a change in ownership of a substantial portion of T’s assets, because T’s old shareholders own 50 percent or more of P after the merger. The merger *does*, however, result in a change in P’s ownership.

(3) If a person or group already has ownership or effective control of T, the acquisition of additional stock or additional control by that person or group is not treated as a further change.

(4) When T redeems stock from one or more shareholders, thereby increasing the percentage of T’s stock owned by T’s other shareholders, those increases are taken into account, so that a sufficiently large redemption from one or more shareholders may result in other shareholders’ stock ownership increasing sufficiently to constitute a change.

(5) Section 318’s attribution rules apply in determining stock ownership.¹⁴ Under section 318(a)(4), the holder of an option to acquire T stock is generally considered to own that T stock. For this purpose, however, an option is not considered outstanding stock if it is not currently exercisable and will become exer-

cisable only on occurrence of a substantial condition precedent.¹⁵

(6) For purposes of the golden parachute rules generally, all members of the same affiliated group (using section 1504(a)’s 80-80 test, but without regard to the section 1504(b) exceptions)¹⁶ are treated as a single corporation. Accordingly, T and its subsidiary S are viewed as a single corporation and a transfer of S’s stock is viewed as a change in ownership of part of T’s assets, rather than a change in ownership of S’s stock.

Example 6

T is the parent of an affiliated group that includes S. T sells all S’s stock to P. S’s assets comprise 20 percent of T group’s gross assets. For purposes of determining whether a change has occurred, T group is viewed as a single corporation and the sale of S stock is viewed as a sale of T group assets.

Because the assets deemed sold constitute less than one-third of T group’s gross assets, the sale does not result in application of the golden parachute rules to T, S, or any other member of T group.

Example 7

Same as Example 6, except that S’s assets comprise 40 percent of T group’s gross assets. Because T group is deemed to have sold assets constituting at least one-third of T group’s gross assets, the golden parachute rules are triggered with respect to T, S, and T group’s other members.

Example 8

T owns 79 percent of S’s stock and the remainder of S’s stock is owned by unrelated persons, so that S is not a member of T’s affiliated group. The S stock owned by T comprises 20 percent of T group’s gross assets. T sells all its S stock to P.

The sale results in a change in S’s ownership, but does not result in a change in ownership of a substantial portion of T group’s assets (because the S stock comprises less than one-third of T group’s gross assets).

Example 9

Same as Example 8, except that the S stock owned by T comprises 40 percent of T group’s gross assets.

¹²T.D. 9083, *Doc 2003-18027 (28 original pages)*, 2003 TNT 154-9, Explanation of Provisions and Summary of Comments, Change in Ownership or Control.

¹³LTRs 199905012, *Doc 1999-5122 (6 original pages)*, 1999 TNT 25-77; 200029035, *Doc 2000-19655 (5 original pages)*, 2000 TNT 142-19; 200029042, *Doc 2000-19662 (6 original pages)*, 2000 TNT 142-20; 200041020, *Doc 2000-26380 (7 original pages)*, 2000 TNT 201-11; 200110009, *Doc 2001-6929 (6 original pages)*, 2001 TNT 48-24; and 200348012, *Doc 2003-25412 (6 original pages)*, 2003 TNT 230-25.

¹⁴Reg. section 1.280G-1 Q&A 27 through 29. See also 1989 and 2002 prop. reg. section 1.280G-1 Q&A 27 through 29.

¹⁵Reg. section 1.280G-1 Q&A 17(b) and (c), example (1); LTR 199914032, *Doc 1999-13362 (6 original pages)*, 1999 TNT 69-52, citing Rev. Rul. 89-64, 1989-1 C.B. 91. See also 2002 prop. reg. section 1.280G-1 Q&A 17(b), example (1).

¹⁶See Martin D. Ginsburg and Jack S. Levin, *Mergers, Acquisitions, and Buyouts* (hereinafter *Ginsburg and Levin Treatise*) paras. 211.1 and 1205.2.

The sale results in a change in S's ownership and also results in a change in ownership of a substantial portion of T group's assets.

The interplay of the different change rules is illustrated by a 2003 private ruling¹⁷ in which (1) Bigco formed new S and dropped more than one-third of the Bigco affiliated group's gross assets into S, (2) Bigco distributed all of S's stock to Bigco's shareholders (and a small amount of S's stock to Bigco's security holders), (3) new P was formed for the purpose of acquiring S and unrelated T, and (4) new P did acquire both S and unrelated T in exchange for P stock, with S's shareholders acquiring more than 50 percent of P's stock outstanding after the T and S acquisitions. The ruling viewed Bigco's step (2) distribution of S stock and P's step (4) acquisition of S and T as separate transactions, and held that Bigco's step (2) distribution did not result in a change in ownership of a substantial portion of Bigco's assets (because Bigco's shareholders owned more than 50 percent of S's stock after the step (1) distribution) and P's step (4) acquisition of S and T did not result in a change in S's ownership (because S's shareholders owned more than 50 percent of P's stock after the acquisition) or in S's effective control (although there was more than a 20 percent change in S's stock ownership, presumption was rebutted by the facts) but did result in a T change in ownership (because S's shareholders acquired more than 50 percent of P's stock and P owned 100 percent of T after step (4)).

IV. 'Contingent' on Change Defined

A. In General

In general a payment is contingent on a change in ownership or control if the executive either (a) acquires a right to receive the payment or (b) receives the payment sooner than he otherwise would have, in either case (i) as a result of the change, or (ii) as a result of events closely associated with the change, or (iii) (absent rebuttal of a presumption) pursuant to a contract entered into or amended within one year before the change.

Under the regulations, when a change accelerates the time for receiving a payment that was previously vested or accelerates the vesting of a right that was previously subject only to time vesting, only a portion of the payment is treated as contingent on the change, as described in F and G of this part IV.

B. Payment Resulting From Change

A payment generally is treated as contingent on a change "unless it is substantially certain, at the time of the change, that the payment would have been made whether or not the change occurred."¹⁸

¹⁷LTR 200348012, note 13 *supra*.

¹⁸1984 Blue Book at 201; S. Rep. No. 313, 99th Cong., 2d Sess. 915 (1986) (1986 Senate Report); reg. section 1.280G-1 Q&A 22. See also 1989 and 2002 prop. reg. section 1.280G-1 Q&A 22.

Example 10

On January 1 year 1 executive A receives T stock subject to a substantial risk of forfeiture (an SRF). The SRF will lapse if A continues to be employed by T until December 31 year 2 or, if earlier, on a change in T's ownership. A change in T's ownership occurs on November 30 year 2 (resulting in SRF lapse). A remains employed by T through December 31 year 2.

Because the SRF lapse (absent the change) was not substantially certain at the time of the change, accelerated vesting of the restricted stock on account of the change is treated as contingent on the change, notwithstanding that A, in fact, did remain employed by T until December 31 year 2.

See part IV.G below for a discussion of the rule that, when a change accelerates the vesting of a payment (including restricted stock) that was formerly subject only to time vesting based on the executive's continued performance of services, only a portion of the payment is treated as contingent on the change.

C. Closely Associated Payment

Generally, a payment is also treated as contingent on a change if:

- (1) the payment is contingent on an event that is closely associated with a change,
- (2) a change actually occurs, and
- (3) the event is materially related to the change.¹⁹

Under the regulations, an event is treated as closely associated with a change if the event "is of a type often preliminary or subsequent to" a change. A nonexclusive list of "closely associated events" includes:

- onset of a tender offer;
- substantial increase in market price of T's stock within a short period of time before a change;
- termination of employment;
- significant reduction in job responsibilities;
- cessation of listing T's stock on an established market;
- acquisition of more than 5 percent of T's stock by a person (or group) not in control of T; and
- change in T's control as defined in the executive's employment agreement.

The IRS has ruled that a parent corporation's sale of a subsidiary was not an event closely associated with the parent's subsequent change (and hence payments to the subsidiary's executives triggered by the parent's sale of the subsidiary were not treated as contingent on the parent's subsequent change) when the parent's decision to sell the subsidiary was made prior to the parent's receipt of the unsolicited offer for the parent that led to the parent's change.²⁰

¹⁹Reg. section 1.280G-1 Q&A 22(b). See also 1989 and 2002 prop. reg. section 1.280G-1 Q&A 22(b).

²⁰LTR 9847011, Doc 98-33701 (6 pages), 98 TNT 225-23.

A material relationship is presumed to exist if the event occurs within (and is presumed *not* to exist if it occurs more than) one year before or after the change.²¹

Example 11

Under an employment contract that T entered into on January 1 year 1, executive A is entitled to a \$500,000 severance payment in the event his employment is terminated. A change in T's ownership occurs on February 1 year 2. On April 1 year 2, as a result of differences in management philosophy between A and T's new owner, A's employment is terminated and he receives the severance payment.

The payment is probably treated as contingent on the change because it is contingent on an event closely associated with a change (termination of A's employment), the change actually occurred, the termination was within one year after the change and hence is presumed to be materially related to the change, and the facts do not support rebuttal of the presumption.

Example 12

Same as Example 11, except that A's employment termination occurs on September 1 year 2 as a result of unanticipated T losses unrelated to T's February 1 year 2 change.

The payment should *not* be treated as contingent on the change. Although A's termination within one year after the change is presumed to be materially related to the change, a showing that the termination resulted from unanticipated losses unrelated to the change should rebut the presumption.

Example 13

Same as Example 11, except that A's employment termination occurs on April 1 year 3.

The payment should *not* be treated as contingent on the change because A's termination more than one year after the change is presumed not materially related to the change.

Example 14

Same as Example 13, except that under A's employment contract, A was entitled to a severance payment only in the event his employment termination occurred after a change.

The payment is treated as contingent on the change — regardless of when or why the termination occurs — under the rule discussed in part IV.B.

²¹Reg. section 1.280G-1 Q&A 22. See also 1989 and 2002 prop. reg. section 1.280G-1 Q&A 22.

D. Agreement Within One Year Before Change

Any payment under an agreement entered into or an amendment made within one year before a change is *presumed* contingent on that change, absent clear and convincing evidence to the contrary.²² The 1984 Blue Book states that the presumption is confirmed if, at the time the contract was entered into, the corporation "viewed itself as a likely takeover candidate" or "had been advised by its investment banker that it was a prime takeover candidate."²³

The regulations state that factors relevant to determining whether the presumption is rebutted include the content of the agreement and the circumstances surrounding execution of the agreement, such as whether the agreement was entered into at a time when a takeover attempt had commenced and the degree of likelihood a change would actually occur. A regulatory example indicates that the fact that a payment is made before a change occurs does not necessarily rebut the presumption.

The regulations state that the presumption is generally rebutted if the agreement (a) is one of a specified list of nondiscriminatory employee benefit programs, or (b) replaces a prior contract and provides no increased payments other than normal increases attributable to additional responsibilities or cost of living adjustments, or (c) grants benefits not significantly different than those granted under contracts with individuals providing similar services (if the other contracts were not themselves entered into in contemplation of the change).²⁴

Example 15

On March 1 year 1 T is advised by its investment banker that T is a takeover candidate. On April 1 year 1, to induce executive A to remain with T despite the takeover threat, T agrees to make a substantial payment to A on April 1 year 2. On January 1 year 2 T is acquired by P.

The payment is presumed contingent on a change in control, and under the circumstances rebuttal of the presumption is highly unlikely.

E. Agreement After Change

The regulations state that a payment is not treated as contingent on a change if the payment is made under an agreement entered into after the change (and no *legally enforceable* agreement existed before the change).²⁵

Two cautionary points: First, when an agreement was negotiated before the change and executed shortly after the change, there is substantial risk the IRS will take the position that a legally enforceable agreement existed before the change. Second, if, after a change, an

²²Section 280G(b)(2)(C).

²³1984 Blue Book at 202.

²⁴Reg. section 1.280G-1 Q&A 26. See also 1989 and 2002 prop. reg. section 1.280G-1 Q&A 26.

²⁵Reg. section 1.280G-1 Q&A 23. See also 1989 and 2002 prop. reg. section 1.280G-1 Q&A 23.

employee surrenders prechange rights (which would have constituted a parachute payment) in exchange for benefits under a new agreement, the new benefits may constitute parachute payments.

These cautionary points are illustrated by the pro-IRS decision in *Cline v. Commissioner*,²⁶ in which T, the target of P's tender offer, entered into written severance agreements with T senior executives. After P successfully completed its tender offer for T, the parties realized that payments under the original severance agreements would run afoul of the golden parachute rules. Seeking to avoid this result, T and the executives entered into written amended severance agreements reducing the amounts payable to each executive below the three-times-base-amount threshold. In connection with negotiating the reduced payments, P orally assured the executives that P would make a good faith effort to compensate them for the reduction in payments but could make no binding promises. The executives subsequently received compensation payments closely corresponding to the amounts by which their original severance payments had been reduced, which amounts the Tax Court found to be substantially in excess of reasonable compensation for the minor consulting and administrative services actually rendered after the change.

The Seventh Circuit's Cline decision is subject to at least two possible readings.

The Tax Court found that P's "best efforts" undertaking to provide that compensation was a legally enforceable agreement entered into before the change, and therefore the excessive compensation for postacquisition services was subject to the golden parachute rules. The court's analysis seems guided by its statement of "concern that other similarly situated disqualified individuals . . . might attempt to avoid [the golden parachute rules] by restructuring the timing and characterization of parachute payments in the future."

On appeal, the Seventh Circuit, relying on the broad language of the statute and legislative history (including an example in the Joint Tax Committee Bluebook characterizing as a parachute payment amounts paid "pursuant to a formal or informal understanding reached before the change occurs") held that the payments would constitute parachute payments even if no legally enforceable agreement existed at the time of the change: "Section 280G's applicability is not contingent on the existence of a legally enforceable agreement."

The Seventh Circuit's *Cline* decision is subject to at least two possible readings:

Under a *narrow* (pro-taxpayer) reading, there was a prechange agreement (indeed a legally binding written

prechange agreement, the original written severance agreement) calling for payments greater than the three-times-base-amount threshold, and hence the later reduction of the amounts to be paid under the severance agreement constituted either a sham or bargained-for consideration for P's promise to pay an amount equal to the reduction. This narrow reading is supported by the *Cline* case's facts (there was a prechange binding written agreement) and is also supported by one sentence in the appellate court's opinion: "The Tax Court . . . was entitled to conclude the second oral agreement was made simply to circumvent tax restrictions."

The regulations contain a rule consistent with this narrow reading of *Cline*, stating that "if an individual has a right to receive a payment that would be a parachute payment if made under an agreement entered into prior to a change . . . and gives up that right as bargained-for consideration for benefits under a postchange agreement, the agreement is treated as a postchange agreement only to the extent the value of the payments under the agreement exceed the value of the payments under the prechange agreement."²⁷

Under a *broader* (more antitaxpayer) reading of *Cline*, a payment after the change can be contingent on the change for section 280G purposes even where the payment is unrelated to any binding prechange agreement to make the payment. This broader reading is suggested by the Seventh Circuit's repeated statements, over several pages of the opinion, that no legally enforceable prechange agreement is necessary:

- "We cannot accept [the executive's] view that a legally enforceable agreement is a necessary predicate to a determination that the payments constitute a golden parachute."
- The statute "does not require that the payment be made pursuant to a legally enforceable agreement or contract."
- "Section 280G's applicability is not contingent on the existence of a legally enforceable agreement."
- "Whether the oral agreement [to use good faith efforts to pay an amount equal to the reduction in T's written obligation] . . . fails for indefiniteness under Illinois law . . . is of no import."

Despite the Seventh Circuit's broad statements, the broader reading of *Cline* should be foreclosed by subsequent finalization of the regulations (under which a payment is not treated as contingent on a change in control when the payment is made under an agreement entered into after the change and no legally enforceable agreement existed before the change).

The Tax Court's 2003 *Square D* decision²⁸ follows the *narrower* reading of *Cline* and is consistent with the regulations. In *Square D*, before P's acquisition of

²⁶34 F.3d 480, 94-2 U.S.T.C. para. 50,468, Doc 94-8348, 94 TNT 179-76 (7th Cir. 1994), *aff'g* *Balch v. Commissioner*, 100 T.C. 331, Doc 93-4505 (33 pages), 93 TNT 81-15 (1993).

²⁷Reg. section 1.280G-1 Q&A 23(a) and (b), example (3). See also 2002 prop. reg. section 1.280G-1 Q&A 23(a) and (b), example (3).

²⁸*Square D Co. v. Commissioner*, 121 T.C. 11, Doc 2003-21341 (120 original pages), 2003 TNT 188-68 (2003).

COMMENTARY / SPECIAL REPORT

publicly traded T, certain T executives entered into employment agreements entitling them, on a T change of control, to lump sum payments that would have been excess parachute payments. P sought to retain the executives' services following the acquisition and, after the ownership change, negotiated new employment agreements with them. The executives used their rights under the prechange agreements as leverage to secure larger payments under the postchange agreements than they would have received under the prechange agreements, but the payments were conditioned on the executives remaining P employees or ceasing P employment under only specified conditions.

The Tax Court's 2003 Square D decision follows the narrower reading of Cline and is consistent with the regulations.

The Tax Court found that the payments under the postchange agreements, excluding the portion qualifying as reasonable compensation for postchange services (see part V.C below), were "contingent on a change in ownership or effective control" within the meaning of section 280G, because "they would not have been made but for the change in ownership." The court's decision turned on whether the agreements entered into after T's change were made "pursuant to" a legally enforceable agreement that was entered into before the change.²⁹ In interpreting the meaning of "pursuant to," the court agreed with the IRS's position that "if a legally enforceable prechange agreement is the proximate cause of provisions in a postchange agreement, the latter agreement is treated as executed 'pursuant to' the former agreement within the proposed regulations." The court found that the executives used their rights to payments under the prechange agreements as "a sword in their negotiations" with P, that the prechange rights enabled the executives to secure lump sum payments under the postchange agreements, and therefore the payments (excluding the portion qualifying as reasonable compensation for postchange services) were contingent on the change.

F. Acceleration of Vested Benefits

When the timing of a payment is accelerated by a change, but the payment was, without regard to the change, (1) "vested" (under the language of the final and 2002 proposed regulations) or (2) "substantially certain" to have been made (under the language of the 1989 proposed regulations), the payment is treated as contingent on the change only to the extent acceleration increases the payment's present value.³⁰ In general, a

²⁹Reg. section 1.280G-1 Q&A 23. See also 1989 and 2002 prop. reg. section 1.280G-1 Q&A 23.

³⁰Reg. section 1.280G-1 Q&A 24. See also 1989 and 2002 prop. reg. section 1.280G-1 Q&A 24.

discount rate equal to 120 percent of the applicable federal rate (AFR) is used to determine present value.³¹

For this purpose, a payment that is subject to an SRF is not treated as vested (or substantially certain) even if the executive timely files a section 83(b) election — since the election does not eradicate the SRF, but merely invokes section 83(b) income tax treatment in place of section 83(a) income tax treatment.³²

See part IV.G below for a discussion of the rule that, when a change accelerates vesting of a payment that was formerly subject only to time vesting based on the executive's continued performance of services, only a portion of the payment is treated as contingent on the change.

When the amount of such a vested payment is not reasonably ascertainable (i.e., the amount of the payment, absent acceleration, is contingent or fluctuating) and the acceleration does not significantly increase the present value of the payment absent acceleration, the acceleration is treated as not increasing the present value of the payment at all.³³ When the amount of a vested payment is not reasonably ascertainable and the acceleration does significantly increase the present value of the payment, the regulations treat that payment's future value as equal to the full amount of the accelerated payment (i.e., the recipient is not given credit for any potential increase in the amount of the payment, absent the change-related acceleration), so that the amount treated as contingent on the change is the amount produced by the 120 percent discount formula applied to the accelerated payment.³⁴

Example 16

On January 1 year 1 T establishes a fully vested deferred compensation account for A, funded through a rabbi trust arrangement (so that the trust assets are available to T's creditors and A does not recognize income). The trust assets are invested and earn a market rate of return. A's account balance will be paid to A on January 1 year 10 or, if earlier, the date of a T ownership change. On January 1 year 5, a T ownership

³¹Reg. section 1.280G-1 Q&A 24, 32, and 33. See also 1989 and 2002 prop. reg. section 1.280G-1 Q&A 24, 32, and 33.

³²The term "vested" as used in reg. section 1.280G-1 Q&A 24 and 2002 prop. reg. section 1.280G-1 Q&A 24 apparently means "substantially vested" within the meaning of reg. section 1.83-3(b) and (j). Cf. reg. section 1.280G-1 Q&A 12(a) and 2002 prop. reg. section 1.280G-1 Q&A 12(a). Hence, filing a section 83(b) election does not cause property or a payment subject to an SRF to be treated as "vested."

³³Reg. section 1.280G-1 Q&A 24(b), reg. section 1.280G-1 Q&A 24(f), example (2); LTR 200110013, Doc 2001-6933 (8 original pages), 2001 TNT 48-25. See also 1989 and 2002 prop. reg. section 1.280G-1 Q&A 24(b), 2002 prop. reg. section 1.280G-1 Q&A 24(f), example (2), 1989 prop. reg. section 1.280G-1 Q&A 24(e), example (3).

³⁴Reg. section 1.280G-1 Q&A 24(b) and 24(f), examples (4), (5), and (6). See also 2002 prop. reg. section 1.280G-1 Q&A 24(b) and 24(f), examples (4), (5), and (6).

change occurs and the then-current trust account balance of \$1 million is paid to A.

Because the amount of A's vested January 1 year 10 payment is not reasonably ascertainable and acceleration of payment resulting from the January 1 year 5 ownership change does not significantly increase the payment's present value, no portion of the \$1 million payment to A is treated as a parachute payment.

Example 17

Same as Example 16 except that A's account balance is credited with only 40 percent of the earnings generated by the trust assets held (with 60 percent of the earnings reverting to T) and the AFR for January year 5 is 5 percent.

Acceleration of A's payment because of the year 5 change significantly increases the present value of A's payment, and hence A is not given credit for any potential increase in the account balance between January 1 year 5 and January 1 year 10. A is treated as receiving a parachute payment equal to \$252,742, i.e., the increase in the present value resulting from a five-year acceleration of a \$1 million payment ($\$252,742 = \$1 \text{ million} \text{ minus } \$747,258$ [which is the present value as of January 1 year 5 of \$1 million to be received on January 1 year 10 using a 6 percent per annum discount rate, 6 percent being 120 percent of the 5 percent AFR]).

Under the regulations a payment (or portion thereof) that arises out of an agreement entered into within one year before the change or an amendment within the corresponding one-year period of a previous agreement is not subject to the taxpayer-favorable rule discussed in this part IV.F, unless clear and convincing evidence demonstrates the payment is not contingent on the change.³⁵

A 2000 letter ruling applied these concepts to find that executives who, as part of a T-P merger, exchanged T options for P options did not receive a payment contingent on a change notwithstanding that, because of fluctuations in the value of P's stock, the T option holders effectively received higher per share consideration than the T shareholders.³⁶ In the ruling, public T was acquired by public P in a merger for consideration intended to consist of two-thirds cash and one-third P stock. The cash portion of the consideration was a fixed per-share amount, while the stock portion was calculated based on the average trading price (within a specified range) of P's stock for a period before the merger (the valuation period). As it turned out, the stock exchange ratio did not reflect the full value of P's stock on the merger date, because the market price for P's stock rose above the specified range during the valuation period so that the stock

portion represented more than one-third of the actual consideration (based on P stock's actual market price on the merger date).

In connection with the merger, vested T options were exchanged 100 percent for vested P options (but no cash), based on the stock exchange ratio used in the merger agreement. Because the exchange ratio "undervalued" P shares (in relation to P shares' actual value on the merger date), the exchanging T option holders (who received all P options and no cash) ended up with a somewhat better deal than the T shareholders (who received predominantly cash). Relying on a representation that the exchange ratio determination was the subject of arm's-length negotiations between T and P and was not intended to provide any compensatory benefit to the T executives, the IRS ruled the exchange of vested T options for vested P options was not a payment in the nature of compensation for section 280G purposes.

G. Accelerated Vesting of Benefit Previously Subject Only to Time Vesting

The regulations state that only a portion of a previously *unvested* payment is treated as contingent on the change when vesting of the payment is accelerated by the change, but the payment was previously (1) "contingent only on the continued performance of services . . . for a specified period of time" (under the language of the final and 2002 proposed regulations) or (2) "substantially certain . . . to have been made without regard to the change if the . . . individual had continued to perform services . . . for a specified period of time" (under the language of the 1989 proposed regulations). The final and 2002 proposed regulations add the requirement that the payment must be "attributable, at least in part, to the performance of services before the date the payment is made or becomes certain to be made" (the "attributable-in-part-to-prechange-services requirement").

The portion of the payment treated as contingent on a change under this taxpayer-favorable rule is equal to the sum of:

- (1) the increase in the payment's present value resulting from the acceleration, ignoring the prior SRF, using a discount rate equal to 120 percent of the AFR to determine the amount of such increase and, subject to the modifications described below, calculated under the rules described in part IV.F, plus
- (2) an amount "reflecting the lapse of the obligation to perform services," which is 1 percent of the accelerated payment per full month under the final and 2002 proposed regulations (and which under the 1989 proposed regulations was based on all facts and circumstances, but *at least* 1 percent of the accelerated payment per full month).³⁷

The final and 2002 proposed regulations simply specify the 1-percent-per-month amount. Although the

³⁵Reg. section 1.280G-1 Q&A 24(a)(1).

³⁶LTR 200032017, Doc 2000-21137 (8 original pages), 2000 TNT 158-5.

³⁷Reg. section 1.280G-1 Q&A 24. See also 1989 and 2002 prop. reg. section 1.280G-1 Q&A 24.

COMMENTARY / SPECIAL REPORT

1989 proposed regulations characterized 1 percent per month as a minimum amount, in practice the 1 percent amount was typically used in the case of all accelerated vesting of stock, stock options, and various forms of deferred compensation, and a series of identical 2000 IRS rulings seemed to bless this practice.³⁸

Under the final and 2002 proposed regulations, the increase in the payment's present value resulting from the acceleration is determined under the rules described in part IV.F.

However, any "acceleration of the vesting of a stock option or the lapse of a restriction on restricted stock is considered to significantly increase the [present] value of a payment," so that, in applying the two-part formula set forth above, the amount treated as contingent on the change under part (1) above is calculated by applying the 120 percent discount formula to the accelerated payment.³⁹ This taxpayer-unfavorable modification does not apply to accelerated vesting of payments other than stock options or restricted stock; for example, this modification does not apply to a stock appreciation right or deferred compensation, so that if the amount of the payment (absent acceleration) is not reasonably ascertainable and the acceleration does not significantly increase the present value of the payment (absent acceleration), the acceleration is not treated as increasing the present value of the payment under part (1) above at all. Under the 1989 proposed regulations, this taxpayer-unfavorable modification applied to accelerated vesting of any type of payment the value of which (absent acceleration) was not reasonably ascertainable.⁴⁰

Example 18

Executive A holds options to purchase 100,000 T shares at a price of \$10 per share (\$1 million aggregate exercise price). A's options are subject to an SRF based on A's continued employment, which will lapse on December 31 year 1 or, if earlier, on a change in T's ownership. On July 15 year 1, when A's options are in the money by \$1 million, a change in T's ownership occurs and A receives a \$1 million payment in cancellation of the stock options. Assume that the AFR for July of year 1 is 5 percent.

The portion of the stock option cancellation payment treated as contingent on a change is \$76,764: the sum of (a) the increase in the present value resulting from a 5½ month acceleration of a \$1

million payment (\$26,764 = \$1 million *minus* \$973,236 [which is the present value as of July 15 year 1 of \$1 million to be received on December 31 year 1 using a 6-percent-per-annum discount rate, 6 percent being 120 percent of the 5 percent AFR]) and (b) 1 percent of the payment per full month (i.e., ignoring the half month) of acceleration (\$50,000 = \$1 million × 1 percent × 5).

The taxpayer-favorable rule treating as contingent on a change only a portion of payments (determined by the two-part formula set forth above) resulting from accelerated vesting of an amount subject only to time vesting conflicts in certain circumstances with another regulatory rule that generally treats the full amount of severance payments triggered by a change as contingent on the change.⁴¹ Severance payments under an employment contract are often measured by reference to the amount of compensation that would have been payable had the employee remained employed for the full term of the contract. A severance payment so computed is one that, read literally, is "contingent only on the continued performance of services . . . for a specified period of time" (under the language of the final and 2002 proposed regulations) and is "substantially certain . . . to have been made without regard to the change if the disqualified individual had continued to perform services . . . for a specified period of time" (under the language of the 1989 proposed regulations) and hence fits within the general language of the taxpayer-favorable rule for accelerated vesting of payments subject only to time vesting, a result not intended by the IRS and Treasury.

The final and 2002 proposed regulations attempt to resolve this conflict by imposing an additional hurdle to the taxpayer-favorable rule that accelerated vesting causes only a portion of a previously unvested payment (which was contingent only on continued performance of services) to be treated as contingent on the change: This additional hurdle disqualifies a "payment . . . due under an employment agreement on a termination of employment or a change in ownership or control that otherwise would be attributable to the performance of services . . . during any period that begins after the date of [employment] termination or change in ownership or control, as applicable"⁴² (the "otherwise-attributable-to-services-after-the-change disqualification").

Example 19

On January 1 year 1 executive A enters into a three-year employment agreement with T, entitling A to \$300,000 fixed annual salary, \$100,000 fixed annual minimum bonus, and additional annual bonus based on satisfaction of certain performance goals. The employment agreement states that, in the event of a T ownership change,

³⁸LTRs 200046005, *Doc 2000-29545 (10 original pages)*, 2000 TNT 224-20; 200046006, *Doc 2000-29546 (10 original pages)*, 2000 TNT 224-21; and 200046007, *Doc 2000-29547 (10 original pages)*, 2000 TNT 224-22 (applying a 1-percent-per-month factor without discussion or analysis of factual support for such percentage); *cf.* LTR 200110013, note 33 *supra* (describing the amount "reflecting the lapse of the obligation to perform services" as "no less than 1 percent" per month).

³⁹Reg. section 1.280G-1 Q&A 24(c)(3) and (f), examples (4), (5), and (6). *See also* 2002 prop. reg. section 1.280G-1 Q&A 24(c)(3) and (f), examples (4), (5), and (6).

⁴⁰1989 prop. reg. section 1.280G-1 Q&A 24(c)(1).

⁴¹Reg. section 1.280G-1 Q&A 44. *See also* 1989 and 2002 prop. reg. section 1.280G-1 Q&A 44.

⁴²Reg. section 1.280G-1 Q&A 24(d)(2). *See also* 2002 prop. reg. section 1.280G-1 Q&A 24(d)(2).

A will receive a lump sum payment equal to the sum of (1) A's fixed salary multiplied by the employment agreement's remaining period (including fractions of a year), plus (2) the highest annual bonus received by A during the preceding three years multiplied by the number of remaining years (including fractions of a year) under the employment agreement.

On January 1 year 2 there is a change in T's ownership. A's highest annual bonus received during the preceding three years was \$200,000. Under the change in ownership provision in A's employment agreement, A receives a \$1 million lump sum payment (\$300,000 fixed salary x two-year remaining term, plus \$200,000 highest bonus x two-year remaining term).

Although A's fixed annual salary and minimum annual bonus for years 2 and 3 (aggregating \$800,000) were substantially certain to have been paid without regard to the change if A had continued to perform services for T, the IRS's position is that the full amount of A's \$1 million payment is treated as contingent on T's change.⁴³

This result is achieved under the final and 2002 proposed regulations on the ground that the payment is "due under an employment agreement on a termination of employment or a change in ownership or control that otherwise would be attributable to the performance of services . . . during any period that begins after" the January 1 year 2 change.

A 2001 letter ruling reached the same result under the 1989 proposed regulations, reasoning that the special rule treating only a portion of accelerated time-vesting payments as contingent on a change "was included in the [1989] proposed regulations to reduce the contingent portion of a nonvested payment that had been partially earned by the taxpayer with services, but had not been paid. This does not occur with amounts paid under an employment agreement because these amounts are paid as they are earned."⁴⁴

It appears likely that the IRS and Treasury intend the otherwise-attributable-to-services-after-the-change disqualification to apply only to payments like severance pay, and not to other types of payments like options or restricted stock. The regulatory language imposes this disqualification only on a "payment . . . due under an employment agreement." While this language could be read as including stock options or restricted stock that happen to be included in an executive's employment agreement (rather than in a separate document), a more rational reading of the regulatory language is that the IRS and Treasury meant

this disqualification to apply only to payments in the nature of salary and bonus for future services no part of which was yet earned (for example, a contractual right to severance pay equal to the executive's salary and bonus that would otherwise have accrued under his employment agreement for services to be rendered after the change date but were payable — without the rendition of services — on account of the change). So read, the otherwise-attributable-to-services-after-the-change disqualification is not relevant to stock options or restricted stock vesting over a period that began before the change, so that such items are subjected only to the attributable-in-part-to-prechange-services requirement.

Indeed, the regulatory examples strongly support this interpretation. Six regulatory examples deal with unvested rights that will vest based on the executive's performance of services for a specified period but which vest early because of a change. Five of those examples deal with accelerated vesting of (1) supplemental retirement plan benefits, (2) a front-end retention bonus, (3) a stock bonus, (4) a nonqualified stock option (NQO) subject to cliff-vesting, and (5) NQOs vesting one-third each on three dates,⁴⁵ and each of these five examples explicitly applies (and finds satisfied) the attributable-in-part-to-prechange-services requirement but ignores (that is, does not mention) the otherwise-attributable-to-services-after-the-change disqualification. None of these five examples discusses whether the executive's unvested benefit is contained in his employment agreement or in a separate document. On the other hand, the sixth regulatory example,⁴⁶ dealing with an executive's right to "be paid the present value of the remaining salary under [his] employment agreement" on a change, explicitly applies the otherwise-attributable-to-services-after-the-change disqualification, "because the payment represents future salary under an employment agreement."

Thus, we believe the otherwise-attributable-to-services-after-the-change disqualification is meant to apply only to payments (such as salary and bonus) that constitute future "core" compensation and not to payments like options, restricted stock, and supplemental retirement plan benefits that are compensation for both past and future services.

In any event, the use of the word "period" is inherently ambiguous in the phrase "otherwise would be attributable to the performance of services . . . during any *period* that begins after the date of . . . change" (emphasis added). It appears the IRS and Treasury meant, by this phrase, to exclude severance pay for any day after the termination or change rather than to allow severance pay to fall within the taxpayer-favorable rule if the executive had already rendered services for one day out of a weekly or monthly or yearly period.

⁴³Reg. section 1.280G-1 Q&A 24(f), example (8).

⁴⁴LTR 200110025, Doc 2001-6945 (5 original pages), 2001 TNT 48-26. Although not so explained in the letter ruling, this position could be reconciled with the language of 1989 prop. reg. section 1.280G-1 Q&A 24(c) by viewing the amount "reflecting the lapse of the obligation to perform services" on these facts as equal to the full amount of A's normal salary and bonus payments.

⁴⁵Reg. section 1.280G-1 Q&A 24(f), examples (1)(iii), (3), (4), (5), and (6).

⁴⁶Reg. section 1.280G-1 Q&A 24(f), example (8).

Example 20

On January 1 year 1 executive A enters into a three-year employment agreement with T. In addition to normal salary and bonus payments, A is granted options to purchase 300,000 shares of T common stock at \$10 per share. The options vest one-third on December 31 year 1, one-third on December 31 year 2, and one-third on December 31 year 3, with vesting accelerated on a T change of control. A T change of control occurs on January 31 year 2, at which time T stock is worth \$20 per share, and A receives a \$3 million payment in cancellation of the 300,000 options (\$10 per option). On January 31 year 2 the AFR is 5 percent.

The 100,000 options that vested on December 31 year 1 are not treated as contingent on the January 1 year 2 change because neither their issuance nor their vesting is contingent on the change.

The 100,000 options scheduled to vest on December 31 year 2 are potentially treated as contingent on the change because the January 31 year 2 change accelerates their vesting by 11 months. These options should qualify for the taxpayer-favorable rule for accelerated vesting of payments subject to time vesting, because vesting of A's options (absent acceleration) was contingent only on A's continued performance of services through December 31 year 2 and A's January 31 year 2 accelerated vesting was clearly attributable at least in part to services performed before the January 31 year 2 change (at a minimum, A's services during January year 2, or viewed more expansively A's services for the 13 months from January 1 year 1 to January 31 year 2).

Although, as described above, there is some concern that the ambiguous otherwise-attributable-to-services-after-the-change language could be read to apply to the options that otherwise would have vested on December 31 year 2, we do not believe (as described above) the regulations intend such an interpretation.⁴⁷

Because accelerated vesting of a stock option is deemed to significantly increase the present value of the payment, the portion of the payment treated as contingent on the change is \$162,806: the sum of (a) the increase in present value resulting from an 11-month acceleration of a \$1 million payment (\$52,806 = \$1 million minus \$947,194 [which is the present value as of January 31 year 2 of \$1 million to be received on December 31 year 2 using a 6 percent per annum discount rate (that is, 120 percent of the AFR)]) and (b) 1 percent of the payment per 11 full months of acceleration (\$110,000 = \$1 million × 1 percent × 11).

The 100,000 options scheduled to vest on December 31 year 3 are also potentially treated as con-

tingent on the January 31 year 2 change because the change accelerates their vesting. These options should qualify for the taxpayer-favorable rule for accelerated vesting of payments subject to time vesting, although this result is less clear than for the options scheduled to vest on December 31 year 2. The IRS might argue that the options scheduled to vest December 31 year 3 are attributable only to services performed in year 3 (i.e., after the January 31 year 2 change) and hence not attributable at least in part to services performed before the January 31 year 2 change, although we believe the year 3 options should be viewed as attributable to services expected to be rendered during the full three-year period. As discussed above for the year 2 options, the IRS might also argue that the otherwise-attributable-to-services-after-the-change disqualification applies, but again we think not. Were either IRS argument to prevail, the full \$1 million payment received by A for the year 3 options would be treated as contingent on the change.

However, we believe the more reasonable interpretation views (1) the options vesting on December 31 year 3, like the options vesting on December 31 year 2, as attributable in part to services performed before the January 31 year 2 change, and (2) the otherwise-attributable-to-services-after-the-change disqualification as not applying, so that the portion of the payment treated as contingent on the change is \$337,092: the sum of (a) the increase in present value resulting from a 23-month acceleration of a \$1 million payment (\$107,092 = \$1 million minus \$892,908 [which is the present value as of January 31 year 2 of \$1 million to be received on December 31 year 3 using a 6 percent per annum discount rate]) and (b) 1 percent of the payment per 23 full months of acceleration (\$230,000 = \$1 million × 1 percent × 23).

An example in the final and 2002 proposed regulations is frustratingly ambiguous on this point.⁴⁸ In the example, executive A was, on January 15 year 1, issued options to purchase 30,000 shares of T stock, one-third of which would vest on each of January 15 year 2, year 3, and year 4 (contingent on A continuing to perform services for T "until" each such date) and all of which would vest on a change of control of T. T's ownership changed on January 16 year 3 (after the first two sets of options had vested), accelerating vesting of the third set of options otherwise scheduled to vest on January 15 year 4. Without explanation, the example notes that the third set of options is "attributable, in part, to the performance of services before the change." As discussed above, we believe it most reasonable to view the third set of options as attributable, in part, to services performed during the entire three-year period. However, it is possible that the IRS could view the first

⁴⁷Reg. section 1.280G-1 Q&A 24(f), example (6). See also 2002 prop. reg. section 1.280G-1 Q&A 24(f), example (6).

⁴⁸Reg. section 1.280G-1 Q&A 24(f), example (6). See also prop. reg. section 1.280G-1 Q&A 24(f), example (6).

set of options as attributable to the January 15 year 1 through January 14 year 2 period, the second set as attributable to the January 15 year 2 through January 14 year 3 period, and the third set as attributable to the January 15 year 3 through January 14 year 4 period, in which case the third set of options satisfied by only a one-day margin the requirement that they be “attributable, at least in part, to the performance of services before the date” they vested because of the change (since T’s change occurred on January 16 year 3).

The taxpayer-favorable rule for accelerated vesting of payments subject to time vesting does not apply to accelerated vesting of payments that are subject to performance or other non-time-based vesting. Thus, when a change triggers accelerated vesting of stock or stock options subject to performance vesting, the full value of the stock or option is treated as a payment contingent on the change.⁴⁹

Example 21

On January 1 year 1 executive A enters into a three-year employment agreement with T. In addition to normal salary and bonus payments, A participates in an incentive plan, under which A is entitled to receive, if he continues to be employed by T at the end of year 3, a formula bonus based on the average amount of T’s positive earnings per share for each of years 1, 2, and 3. The employment agreement states that in the event of a change in T’s ownership, A will receive an accelerated payment of amounts under the incentive plan, with the ownership-change year treated as ending on the date of change.

On September 30 year 3 there is a change in T’s ownership. A receives a lump sum payment based on the average of T’s positive earnings per share for each of year 1, year 2, and the portion of year 3 ending on September 30.

The portion of the payment based on partial year 3 positive earnings would not qualify for the taxpayer-favorable rule for accelerated time-vesting payments, because this payment was not subject merely to time vesting without regard to the change (i.e., absent the change, T could have suffered fourth-quarter year 3 losses that would offset T’s positive earnings for year 3’s first three quarters). However, any losses suffered by T during the fourth quarter of year 3 (even if greater than T’s earnings for the first three quarters of year 3) would not have affected the portion of the bonus calculated by reference to year 1 and year 2 positive earnings had A continued to perform services for T through the end of year 3 (because A’s contractual bonus calculation takes into account only a year with positive earnings per

share). Thus, the year 1 and year 2 portion of the bonus should qualify for the taxpayer-favorable rule for accelerated time-vesting payments.⁵⁰

Under the regulations, a payment (or portion thereof) that arises out of an agreement entered into within one year before the change or an amendment within the corresponding one-year period of a previous agreement is not subject to the taxpayer-favorable rule discussed in this part IV.G, unless clear and convincing evidence demonstrates the payment is not contingent on the change.⁵¹

As discussed in the *Ginsburg and Levin Treatise* para. 1502.1.3, the IRS has taken the position in several private rulings that where an executive holding fully vested property subsequently agrees with his employer to subject that property to vesting restrictions, neither the imposition of those vesting restrictions nor the ultimate lapse of those vesting restrictions results in a “transfer” of property for section 83 purposes, and hence the executive does not recognize compensation income as a result of the imposition or lapse of those “subsequently imposed” vesting restrictions. A 2001 private ruling applies this reasoning to conclude that where such a “subsequently imposed” vesting restriction lapses on a change, the executive is not deemed to receive any payment in the nature of compensation for purposes of section 280G.⁵²

H. Agreement Violating Securities Laws

A payment made (1) pursuant to an agreement that violates a generally enforced federal or state securities law or regulation and (2) in connection with a potential or actual change is treated as a parachute payment without regard to whether the payment is contingent on a change or whether the payment’s present value is at least three times the recipient’s base amount.

The regulations presume a violation does not exist unless the existence of the violation has been determined or admitted in a nontax civil, criminal, or administrative action. In addition, violations that are merely technical or are not materially prejudicial to shareholders are ignored.⁵³

If a material securities violation payment is contingent on a change, the payment is treated under the above special rule or under the general golden parachute rules, whichever produces the more antitaxpayer result.

I. Employment Termination Not Required

A payment may be covered “even if the [executive’s] employment . . . is not voluntarily or involuntarily terminated.” If a contract provides for payments on a change, then “[t]he payments are contingent on the

⁵⁰LTR 200110013, note 33 *supra*.

⁵¹Reg. section 1.280G-1 Q&A 24(a)(1).

⁵²LTR 200212005, *Doc 2002-7065 (4 original pages)*, 2002 TNT 57-51.

⁵³Reg. section 1.280G-1 Q&A 37. See also 1989 and 2002 prop. reg. section 1.280G-1 Q&A 37.

⁴⁹Reg. section 1.280G-1 Q&A 24(d)(3); ILM 200043037, *Doc 2000-27597 (7 original pages)*, 2000 TNT 210-55. See also 2002 prop. reg. section 1.280G-1 Q&A 24(d)(3).

COMMENTARY / SPECIAL REPORT

change, even if the [executive] continues in the employ of the corporation.”⁵⁴

V. Reduction for Reasonable Compensation

The amount of a parachute payment is generally reduced by the amount that constitutes reasonable compensation to the recipient.

A. Compensation for Future Services

The amount of a parachute payment is reduced by the portion of the payment that the recipient establishes by clear and convincing evidence is “reasonable compensation for personal services to be rendered *on or after*” the change date.⁵⁵

Example 22

Executive A, a “disqualified individual” with a \$100,000 base amount, receives a \$400,000 payment that is contingent on a change in T’s control. A establishes that \$150,000 of the payment is reasonable compensation for postchange services.

A has received no excess parachute payment because A’s \$250,000 net parachute payment (\$400,000 payment less \$150,000 reasonable compensation) is less than three times A’s \$100,000 base amount.

B. Compensation for Past Services

In computing the amount of an excess parachute payment, the recipient’s parachute payment is reduced by the *greater* of:

- (1) the recipient’s base amount,⁵⁶ or
- (2) the portion of the parachute payment that the recipient establishes by clear and convincing evidence is “reasonable compensation for personal services actually rendered *before*” the change in control date.⁵⁷

Example 23

Same as Example 22, except that clear and convincing evidence demonstrates that \$150,000 of the \$400,000 payment is reasonable compensation for prechange (rather than postchange) services.

A has received a \$250,000 excess parachute payment (rather than \$0 in Example 22), because:

- (a) the \$400,000 parachute payment (which is *not* reduced by reasonable compensation

for *prechange* services) exceeds three times the executive’s \$100,000 base amount:

Parachute payment	\$400,000
Less: 3 times base amount	<u>(300,000)</u>
Excess over 3 times base amount	\$100,000

and

(b) the \$400,000 parachute payment exceeds by \$250,000 the greater of the executive’s base amount (\$100,000) and the portion of the parachute payment that is reasonable compensation for prechange services (\$150,000):

Parachute payment	\$400,000
Less: greater of \$100,000 base amount or \$150,000 reasonable compensation for prechange services	<u>(150,000)</u>
Excess parachute payment	\$250,000

C. Reasonable Comp Determination

Legislative history, regulations, private rulings, and case law furnish the following interpretive guidance:

- (1) If parachute payments “are not significantly greater than amounts of compensation . . . paid to the . . . individual in prior years or customarily paid to similarly situated employees by the employer or by comparable employers,” these facts will “normally” serve as clear and convincing evidence of reasonable compensation.⁵⁸
- (2) “[O]nly in rare cases, if any, will any portion of a parachute payment be treated as reasonable compensation in response to an argument that the executive was undercompensated [in earlier years].”⁵⁹
- (3) Severance payments (and damages for failure to make severance payments) are not treated as reasonable compensation.⁶⁰
- (4) Payments made under certain nondiscriminatory employee benefit programs generally are considered to be reasonable compensation.⁶¹
- (5) An executive’s covenant not to compete can constitute personal services actually rendered in an amount equal to the FV of the covenant,⁶² so long as the noncompete agreement “substantially

⁵⁴H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 861 (1984) (1984 Conference Report); see reg. section 1.280G-1 Q&A 22(d). See also 1989 and 2002 prop. reg. section 1.280G-1 Q&A 22(d).

⁵⁵Section 280G(b)(4)(A) (emphasis added).

⁵⁶Where there are multiple parachute payments (e.g., one at the change and another two years later), the base amount is allocated among the multiple parachute payments based on their relative present values.

⁵⁷Section 280G(b)(4)(B) (emphasis added).

⁵⁸1986 Senate Report at 919-920; reg. section 1.280G-1 Q&A 42. See also 1989 and 2002 prop. reg. section 1.280G-1 Q&A 42.

⁵⁹1984 Blue Book at 205.

⁶⁰1986 Senate Report at 917; reg. section 1.280G-1 Q&A 44. See also 1989 and 2002 prop. reg. section 1.280G-1 Q&A 44.

⁶¹Reg. section 1.280G-1 Q&A 41. See also 1989 and 2002 prop. reg. section 1.280G-1 Q&A 41.

⁶²1984 Blue Book at 204; reg. section 1.280G-1 Q&A 42(b); LTR 200110025, note 44 *supra*. See also 2002 prop. reg. section 1.280G-1 Q&A 42(b).

constrain[s]" the recipient's ability to perform services and there is a "reasonable likelihood" that the agreement will be enforced.⁶³

(6) T's payments to an executive as damages for breach of an employment contract may be treated as reasonable compensation for future services if:

- (a) the contract was not entered into, amended, or renewed in contemplation of the change,
- (b) compensation under the contract is reasonable,
- (c) the damages do not exceed the present value of the compensation the executive would have received if employment had continued,
- (d) the damages are received because the executive offered to provide services and the employer rejected the offer, and
- (e) the damages are reduced by mitigation (for example, by the executive's earned income during the remainder of the period the contract would have been in effect).⁶⁴

(7) The Tax Court's 2003 *Square D* decision⁶⁵ reviews in detail evidence bearing on reasonable compensation for postchange services, with the court concluding that:

- (a) the determination should be made based on a "multifactor" test (which focuses on the executive's prior compensation and the compensation of similarly situated executives), rather than the "independent investor" test (which focuses on whether an independent investor would have been satisfied with its return on investment after payment of the executive compensation),
- (b) to satisfy the clear and convincing evidence standard, it is necessary to establish the reasonableness of compensation on a year-by-year and executive-by-executive basis, rather than merely establishing the reasonableness of compensation over the

term of an employment contract or for all executives as a group, and

(c) to satisfy the clear and convincing evidence standard, evidence of compensation paid by "comparable" employers requires a high degree of comparability.⁶⁶

VI. Additional Definitions and Rules

A. Identity of Payor

Payments may be treated as parachute payments if paid "directly or indirectly" by T, by P, or by any person whose relationship to T or P is such as to require attribution of stock ownership between the parties under section 318, i.e., generally a 50-percent-by-value test.

B. Covered Executive

The rules cover payments to (or for the benefit of) any individual (or any personal service corporation or "similar" entity) who is, with respect to T, both:

- (1) an employee or independent contractor and
- (2) an officer, shareholder, or highly compensated individual.

For purposes of clause (2), an individual's status as a shareholder is disregarded unless the individual owns (directly and by application of section 318's constructive ownership rules) T stock having a value exceeding 1 percent of T's total stock value.⁶⁷ A "highly compensated individual" is one whose annual compensation equals or exceeds a threshold amount (\$90,000, adjusted by an inflation factor for years after 2002) and who is among the smaller of the following two groups:

- (1) the highest-paid 1 percent of individuals performing services for T's affiliated group, or

⁶³Reg. section 1.280G-1 Q&A 42(b). See also 2002 prop. reg. section 1.280G-1 Q&A 42(b).

⁶⁴Reg. section 1.280G-1 Q&A 42(c)(5). See also 2002 prop. reg. section 1.280G-1 Q&A 42(c)(5); 1989 prop. reg. section 1.280G-1 Q&A 42(b)(5). The preamble to the 1989 proposed regulations states that "[t]he proposed regulations do not provide a rule concerning the method of establishing mitigation of damages in other situations, such as where the disqualified individual does not accept alternative employment during the remainder of the contract term or where the individual and the corporation considered mitigation in determining the amount of a lump-sum settlement agreement because IRS is concerned about the administrability of such a rule. Accordingly, IRS solicits comment on how a rule that would allow damages to be treated as mitigated in such cases could be administered." The final and 2002 proposed regulations provide no additional guidance on this issue.

⁶⁵Note 28 *supra*.

⁶⁶For example, the court found that evidence of compensation paid by 10 other publicly traded corporations engaged in the non-high-technology, nondefense sectors of the electrical equipment industry was relevant, but evidence of compensation paid by the largest 250 of 1,000 publicly traded corporations generally was not.

⁶⁷Reg. section 1.280G-1 Q&A 17(a). See also 2002 prop. reg. section 1.280G-1 Q&A 17. Under section 318's constructive ownership rules, stock ownership includes ownership through the deemed exercise of a stock option, other than an option the exercisability of which, at the time of the change, remains subject to a substantial condition precedent. Reg. section 1.280G-1 Q&A 17(c), example (1). See also 2002 prop. reg. section 1.280G-1 Q&A 17(c), example (1); LTRs 200036024, *Doc 2000-23384* (5 original pages), 2000 TNT 176-42; 200036027, *Doc 2000-23387* (5 original pages), 2000 TNT 176-45; 200036031, *Doc 2000-23391* (5 original pages), 2000 TNT 176-46; 200036032, *Doc 2000-23392* (5 original pages), 2000 TNT 176-47; and 200036037, *Doc 2000-23397* (5 original pages), 2000 TNT 176-50, citing Rev. Rul. 89-64, 1989-1 C.B. 91. Under the 1989 proposed regulations, an individual's status as a shareholder would have been disregarded only if the individual owned T stock with a value not exceeding the lesser of \$1 million or 1 percent of T's total stock value. 1989 prop. reg. section 1.280G-1 Q&A 17.

COMMENTARY / SPECIAL REPORT

(2) the highest-paid 250 employees of T's affiliated group.⁶⁸

However, the rules do not cover a nonemployee of T who performs services in the ordinary course of his business for a significant number of clients unrelated to T, such as brokerage, legal, or investment banking services.⁶⁹

An individual is covered if he has the status of a "disqualified individual" at any time during the "disqualified individual determination period," the 12-month period ending on the change date.⁷⁰

C. Base Amount

In general, an individual's base amount is the average annual compensation that T (and any related or predecessor corporation) paid and the individual included in his gross income for the individual's most recent five tax years ending before the change. If an individual has been a service provider to T for less than five full years, this calculation is made for the portion of such five-year period during which the individual was an employee of, or independent contractor for, T, with the individual's compensation for any partial year annualized except for a payment, such as a sign-on bonus, that is not regularly repeated.⁷¹

Thus, an individual's base amount is calculated based on federal income tax principles so that, for example, (1) deferred compensation is included when paid rather than when earned, (2) income from a nonqualified stock option (NQO) is included when the NQO is exercised (where the stock is then vested) or when a postexercise SRF expires (where the stock is subject to a postexercise SRF and the individual makes no section 83(b) election), and (3) a payment in property subject to an SRF is included at the time of receipt when the individual makes a section 83(b) election and at vesting when he makes no section 83(b) election.

Example 24

T pays a bonus to executive A on December 15 year 1 in anticipation of a change in control. A change in T's control actually occurs on January 15 year 2.

This bonus is included in A's year 1 income, and hence increases A's base amount (because A was

paid in year 1, i.e., a year ending before the change).

If the bonus is found to be contingent on a change in T's control, the bonus would presumably be a parachute payment but (a) would be excluded from A's parachute payment amount if A proves that it was "reasonable compensation" for services to be rendered after the change (see parts II(1)(d)(i) and V.A above) and (b) would be a reasonable compensation subtraction from A's excess parachute payment (to the extent greater than A's base amount) if A proves that it was "reasonable compensation" for prechange services (see parts II(3)(b) and V.B above).

D. Deferred Payment

When some or all of a disqualified individual's parachute payments are to be made after the change date, the determination of whether such individual's aggregate parachute payments equal or exceed three times such individual's base amount is made based on the future payments' present value as of the change. The present value of such future payments is calculated using a discount rate equal to 120 percent of the AFR in effect as of the date of the change (unless the contract providing for the payment specifies use of the AFR in effect when the contract was entered into). The regulations also direct use of reasonable actuarial assumptions.⁷²

If the present value of an individual's parachute payments equals or exceeds the three-times-base-amount threshold, section 4999's 20 percent excise tax and section 280G's deduction disallowance apply to the full excess parachute payment (*without* any discounting of the deferred payments). However, the excise tax is generally payable only as each payment is included in the disqualified individual's gross income.⁷³

Example 25

T enters into an agreement with executive A calling for a \$1 million parachute payment payable three years after any change in T's control. A's base amount is \$250,000. A change occurs on June

⁶⁸Section 280G(c) and section 280G(d)(5); reg. section 1.280G-1 Q&A 19(a). See also 2002 prop. reg. section 1.280G-1 Q&A 19(a). The 1989 proposed regulations' threshold amount was \$75,000, not adjusted for inflation. 1989 prop. reg. section 1.280G-1 Q&A 19(a).

⁶⁹Reg. section 1.280G-1 Q&A 19(b). See also 1989 and 2002 prop. reg. section 1.280G-1 Q&A 19(b).

⁷⁰Reg. section 1.280G-1 Q&A 20. See also 2002 prop. reg. section 1.280G-1 Q&A 20. The 1989 proposed regulations' determination period was the portion of T's year (either calendar or fiscal at T's election) ending on the date of the change *plus* the immediately preceding 12-month period. 1989 prop. reg. section 1.280G-1 Q&A 20.

⁷¹Reg. section 1.280G-1 Q&A 34 and 35. See also 1989 and 2002 prop. reg. section 1.280G-1 Q&A 34 and 35.

⁷²Section 280G(d)(4); reg. section 1.280G-1 Q&A 31 and 32. See also 1989 and 2002 prop. reg. section 1.280G-1 Q&A 31 and 32. The final and 2002 proposed regulations state that the present value of an obligation to provide health care over a period of years should be determined in accordance with GAAP and can be measured by projecting the cost of premiums for purchased health care insurance, even if no insurance is actually purchased. Reg. section 1.280G-1 Q&A 31(b)(2); 2002 prop. reg. section 1.280G-1 Q&A 31(b)(2).

⁷³The final and 2002 proposed regulations permit individuals to prepay the excise tax by electing to treat the present value of a future parachute payment as received in the year of the change in control or, if later, the first year in which the future payment becomes certain. Reg. section 1.280G-1 Q&A 11(c). See also 2002 prop. reg. section 1.280G-1 Q&A 11(c).

1 year 1, at which time the AFR is 5 percent. A provides no services to T after the change.

The present value on June 1 year 1 of the \$1 million future payment (discounted at 6 percent — 5 percent x 120 percent) is \$837,484. The parachute payment's present value exceeds three times A's base amount. Accordingly, an excise tax of \$150,000 ((\$1 million - \$250,000) x 20 percent) is imposed on A for his tax year ending December 31 year 4, the year in which the \$1 million parachute payment is includible in A's income (unless A can establish that more than \$250,000 of the parachute payment was reasonable compensation for services rendered before the change).

E. Payment: Options and SRFs

Under the regulations, a parachute payment is generally considered to be made when cash or other property is "transferred" and becomes "substantially vested," as these terms are defined under reg. section 1.83-3. The amount of the payment is generally equal to the property's FV at the time the property becomes substantially vested over the amount (if any) paid for the property.

The regulations diverge from the normal section 83 rules in two respects:

First, a stock option (either NQO or ISO) is treated as "transferred" when it becomes vested (regardless of whether it meets the narrower "readily ascertainable value" standard contained in the section 83 rules).⁷⁴ The value of an option at time of vesting is based on all relevant facts, including the option spread, the term of the option, and the volatility of the underlying stock.⁷⁵ Thus, when an executive receives a stock op-

tion as a parachute payment, the payment is taken into account under the golden parachute rules and its FV is measured when the option vests rather than when exercised.

Second, a section 83(b) election is ignored for purposes of the golden parachute rules, and hence where an executive receives property subject to an SRF — either property issued prior to the change that vests as a result of the change or property issued as a result of the change that vests based on a postchange contingency — the parachute payment attributable to that property transfer is generally taken into account and is measured when the SRF expires, even if a section 83(b) election is made promptly after transfer of the property to the executive.

Because a parachute payment is not deemed to occur until property becomes "substantially vested," if at the time of T's change a T executive receives property that would have constituted a parachute payment if vested, but such property is subject to an SRF, the amount of the parachute payment may be substantially increased by postchange appreciation in the property, and postchange appreciation cannot be removed from the parachute calculation by making a section 83(b) election.

Example 26

Contingent on a change in T's ownership, executive A is allowed to purchase for \$10 per share 100,000 T shares subject to an SRF. At the time of purchase, the FV of T stock (ignoring the SRF) is \$15 per share. When the SRF lapses several years later, the FV of the T stock is \$100 per share. T is treated as receiving, at the time the SRF lapses, whether or not A made a section 83(b) election with respect to the stock purchase, a \$9 million parachute payment (\$10 million FV of T stock less \$1 million purchase price), reduced by the portion of the payment that is established by clear and convincing evidence to constitute reasonable compensation for services rendered by A after the change.

F. Future Uncertain Parachute Payment

If an executive receives a payment contingent on a change and also is or may become entitled to receive another payment contingent on the same change, the determination of whether or to what extent the first payment is an excess parachute payment depends on the present value of the second payment. When the fact, time, or amount of the second payment is uncertain, the present value of the second payment is unknown at the time of the change and may be difficult to estimate.

The regulations apply a more-likely-than-not standard to all parachute payments contingent on an uncertain future event or condition. If, based on a reasonable estimate, there is a 50-percent-or-greater probability that the payment will be made, the present value of the full amount of the payment is taken into account for purposes of (1) determining whether the individual's aggregate parachute payments reach the three-times-base-amount threshold and (2) allocating

⁷⁴Under the final and 2002 proposed regulations, this rule applies to both nonqualified stock options and incentive stock options. Reg. section 1.280G-1 Q&A 13(a). See also 2002 prop. reg. section 1.280G-1 Q&A 13(a). The 1989 proposed regulations reserved on the treatment of incentive stock options.

⁷⁵The final and 2002 proposed regulations grant the IRS authority to publish guidance on valuation of stock options for this purpose. Reg. section 1.280G-1 Q&A 13(a), -1 Q&A 33(c). See also 1989 and 2002 prop. reg. section 1.280G-1 Q&A 13(a). Rev. Proc. 2003-68, 2003-34 IRB 398, *Doc 2003-17913* (12 original pages), 2003 TNT 149-10 (restating and modifying Rev. Proc. 2002-13, 2002-1 C.B. 637, *Doc 2002-4299* (6 original pages), 2002 TNT 35-6, and Rev. Proc. 2002-45, 2002-2 C.B. 40, *Doc 2002-14294* (9 original pages), 2002 TNT 115-12), describes several valuation methods, including a safe harbor approach modeled after the Black-Scholes valuation method, and also approves any valuation method consistent with GAAP (such as FASB 123) and takes into account the factors set forth in the regulations. Rev. Proc. 2003-68 permits T to redetermine the value of an option during the 18-month period following an ownership change if, during this period, there is a change in the option term due to a termination of employment or a change in the volatility of the stock underlying the option. Rev. Proc. 2003-68 is effective January 1, 2004, but taxpayers are permitted to apply it to earlier ownership changes. Rev. Proc. 2002-13 and Rev. Proc. 2002-45, providing similar option valuation rules in connection with the 2002 proposed regulations, are revoked as of January 1, 2004.

the individual's base amount among the various parachute payments. On the other hand, if it is reasonably estimated that there is less than a 50 percent probability that the payment will be made, the payment is disregarded unless and until made.⁷⁶

The regulations do not address how to treat future parachute payments that are contingent in timing or amount. Presumably, a reasonable estimate of the time and amount of payment should be made.⁷⁷

The regulations state that if the actual payments turn out to be different than those estimated, the original parachute calculation must be redone to reflect actual payments. This involves a recalculation of the three-times-base-amount threshold and, if the threshold is exceeded, a reallocation of the base amount among the various parachute payments. This recalculation and reallocation may increase or decrease the portion of the earlier payment treated as an excess parachute payment, resulting in the need to file an amended return and either pay additional tax or claim a refund for the earlier year (assuming that the statute of limitations

⁷⁶Reg. section 1.280G-1 Q&A 33(a) and (d), examples (1) and (2). See also 2002 prop. reg. section 1.280G-1 Q&A 33(a) and (c), examples (1) and (2).

⁷⁷The 1989 proposed regulations contain a more complex rule, stating that "a reasonable estimate of the time and amount of the future payment shall be made, and the present value of the payment will be determined on the basis of this estimate." For this purpose, "an uncertain future event or condition that may reduce the present value of a payment will be taken into account only if the possibility of the occurrence of the event or condition can be determined on the basis of generally accepted actuarial principles or can be otherwise estimated with reasonable accuracy" (emphasis added). Otherwise, the contingency is ignored and the full amount of the potential future payment is taken into account (less present value discounting).

Although the language of the 1989 proposed regulations is opaque, the drafters may have intended to distinguish between (1) conditions precedent to receiving or determining the amount of a payment and (2) conditions subsequent, which might reduce the amount of the payment to which the individual is otherwise entitled. The 1989 proposed regulations can be read as applying a reasonable, good faith valuation standard to category (1) and a more strict actuarial or reasonable accuracy standard to category (2). Thus, an example in the 1989 proposed regulations states that, in the case of a payment that will be made only if the executive's employment is terminated within a specified period (i.e., a category (1) condition precedent), a reasonable estimate should be made of the possibility that the executive's employment will be terminated. The example then states that the reasonable estimate is a 50 percent probability the executive will be terminated and, accordingly, includes 50 percent of the potential payment in applying the golden parachute rules. Conversely, another example deals with a payment to which an executive is entitled, but that will be reduced if the executive earns compensation from another employer (i.e., a category (2) condition subsequent) and concludes that inability to determine "with reasonable accuracy" the likelihood that this condition will occur results in the condition being ignored and the full potential payment being taken into account. 1989 prop. reg. section 1.280G-1 Q&A 33(a) and (c), examples (1) and (2).

has not expired).⁷⁸ The regulations, however, do not require such a recalculation and reallocation if payments to a disqualified individual reached the three-times-base-amount threshold without regard to the contingent future payment and no base amount was previously allocated to that payment.⁷⁹

G. Withholding

To the extent the 20 percent excise tax applies to an excess parachute payment that constitutes "wages," the amount required to be withheld is increased by the amount of the 20 percent excise tax.⁸⁰

VII. Private Companies and Friendly Acquisitions

A. Small or Privately Held Company

Section 280G(b)(5) states that the golden parachute provisions do *not* apply to any payment with respect to a corporation (T) that, immediately before the change, *either*:

- (a) could have elected to be an SCo (determined without regard to the SCo prohibition on nonresident alien shareholders), *or*
- (b) has "no stock . . . readily tradable on an established securities market or otherwise," if (1) the "payment was approved by a vote of the persons who owned, immediately before the change . . . , more than 75 percent of the voting power" of T's stock and (2) "there was adequate disclosure to shareholders of all material facts."

Example 27

T is a subchapter C corporation with one class of stock outstanding. T's shares are held by 70 individual shareholders. T also meets the other qualifications for electing SCo status as set forth in section 1361(b) (except that T has a nonresident alien shareholder).⁸¹

Because T could have elected to be an SCo (except for the non-resident-alien shareholder), T and its executives are exempt from the golden parachute provisions under the exception described in (a) above.

Example 28

Same as Example 27, except that T's stock is held by 76 unrelated individuals, *or* one of T's shareholders is a partnership, nondisregardable LLC,

⁷⁸Reg. section 1.280G-1 Q&A 33; 1984 Blue Book at 205. See also 1989 and 2002 prop. reg. section 1.280G-1 Q&A 33. For an example of the reallocation of base amount among various parachute payments, see LTRs 200046005, 200046006, and 200046007, note 38 *supra*.

⁷⁹Reg. section 1.280G-1 Q&A 33(b) and (d), example (3). See also 2002 prop. reg. section 1.280G-1 Q&A 33(b) and (c), example (3).

⁸⁰Section 4999(c)(1).

⁸¹See *Ginsburg and Levin Treatise* para. 1102 for discussion of SCo qualification rules.

or corporation, or T has more than one class of stock outstanding, but T's stock is not publicly traded. T, immediately before a change in control, prepares and submits to its shareholders a plan to make certain payments to executives contingent on the change. More than 75 percent of T's shareholders (by vote) approve the plan after adequate disclosure.

T and its executives are exempt from the golden parachute rules under the shareholder approval exception described in (b) above, even though T could not have elected to be an SCo.

The regulations describing the shareholder approval exception state that the shareholder vote "must determine the right of the disqualified individual to receive the payment, or in the case of a payment made before the vote, the right of the disqualified individual to retain the payment."⁸² Accordingly, if a disqualified individual is contractually entitled to receive (or has received) a payment, the shareholder approval exception applies to such payment only if the individual agrees to give up his right to receive (or agrees to return) the payment in the event the more-than-75-percent-shareholder-vote requirement is not met.

Example 29

On January 1 year 1, T (no stock of which is readily tradable at any time) enters into an employment contract with A under which A will receive a \$1 million payment in the event of a change in T's control, but at that time there is no T shareholder vote on A's contract. On June 29, year 3, while T is negotiating a change-in-control transaction, A agrees to give up his right to the \$1 million payment if the 75-percent-shareholder-vote requirement is not satisfied. On June 30 year 3 T's shareholders, after adequate disclosure, unanimously vote to approve A's contractual right to the \$1 million payment. Later on June 30 year 3 a change in T control occurs.

The shareholder approval exception applies since A's right to receive the payment was contingent on the more-than-75-percent favorable shareholder vote, there was adequate disclosure to T's shareholders prior to the vote, and holders of more than 75 percent of T's voting power immediately before the change voted in favor of the payment.

In practice, it is often difficult to take advantage of the shareholder approval exception. A (front-end) shareholder vote at the time T and its executive enter into a contract to make a payment (which turns out to be a parachute payment) may not qualify for the exception because of changes in the identity of T's shareholders between the time the contract is entered into and the subsequent ownership change (including changes in the persons to whom disclosure must be

provided), or because subsequent changes in other parachute benefits being provided to executives, or in the actual amount of benefits payable under the contract, render the prior disclosure "inadequate." Although these risks could be avoided by holding a shareholder vote at the time of the change, the executive may be unwilling to expose his right to receive or retain the payment to a back-end shareholder vote.

The regulatory preamble acknowledges that it may be difficult, if not impossible, to satisfy the shareholder approval requirement through a front-end shareholder vote. Specifically, the preamble notes that several commentators recommended "treating approval of a compensation agreement when the agreement is executed as sufficient . . . or deeming shareholders who acquire stock after approval of any compensation agreements to consent to any parachute payments contained in these agreements." The IRS and Treasury, however, rejected these comments, stating that the shareholder approval exception "is based on a vote of those persons who hold shares immediately before the change in ownership or control after adequate disclosure [so that the commentators'] . . . suggested revisions to the shareholder approval requirements are inconsistent with those requirements."⁸³

Example 30

Same as Example 29, except that (1) the unanimous favorable vote of T's shareholders occurs on January 1 year 1 (i.e., a front-end vote), just before T enters into the employment agreement with A, and (2) there is no June 30 year 3 (back-end) shareholder vote.

Setting aside for a moment whether the adequate-disclosure-to-shareholders prong of the test is met (a topic discussed below), the shareholder vote exception appears to apply so long as (between the January 1 year 1 shareholder vote and the June 30 year 3 change) either no T voting stock is transferred, or less than 25 percent is transferred, to persons not T shareholders at the time of the January 1 year 1 shareholder vote.

The statute does not require that the shareholder vote occur immediately before the change, merely that "the payment was approved by a vote of the persons who owned immediately before the change . . . more than 75 percent of [T's] . . . voting power."⁸⁴ Nor do the regulations alter this result, simply (but somewhat ambiguously) stating that "such payment is approved by more than 75 percent of the voting power of all outstanding stock . . . entitled to vote . . . immediately before the change."

For a discussion of the adequate-disclosure-to-shareholders issue presented when less than 25

⁸²Reg. section 1.280G-1 Q&A 7. See also 1989 and 2002 prop. reg. section 1.280G-1 Q&A 7.

⁸³T.D. 9083, note 12 *supra*, Explanation of Provisions and Summary of Comments, Exempt Payments, 3. Shareholder Approval.

⁸⁴Section 280G(b)(5)(B)(i).

percent of T's voting shares are transferred between the shareholder vote and the change, see examples 38-41 and related text.

Example 31

Same as Example 30, except that (1) on March 31 year 3 C acquires 30 percent of T's voting stock from B, a T shareholder who owned such T stock at the time of the January 1 year 1 shareholder vote, and (2) C was already a 2 percent T shareholder on January 1 year 1 and voted the 2 percent of T's stock he held on January 1 year 1 in favor of A's contract.

Subject to the adequate-disclosure-to-shareholder issue discussed below, the shareholder vote exception appears to apply (even though more than 25 percent of T's voting stock is transferred after the January 1 year 1 shareholder vote), since C is a person who voted on January 1 year 1 to approve the contract. Thus, "the payment was approved [on January 1 year 1] by a vote of the persons [including C, who then owned 2 percent of T] who owned immediately before the change [including C who then owned 32 percent of T] . . . more than 75 percent of T's . . . voting power."

The somewhat ambiguous regulations quoted above do not appear to alter this result.

The regulations grant limited relief from the statutory rule identifying the group of shareholders eligible to vote as those owning T voting stock "immediately before the change." A "special rule" in the final regulations allows "the determination of the shareholders eligible to vote on the payment [to be] based on the shareholders of record as of any day within the six-month period immediately prior to and ending on the date of the change . . . , provided the disclosure requirements . . . are met."⁸⁵

Read literally, this special regulatory rule (1) applies only when the record date used in determining the T shareholders entitled to vote falls within six months before the change and (2) does not apply when the shareholder vote was taken either more than six months before the change or less than six months

before the change but based on a shareholder record date more than six months before the change. Under this reading, a shareholder vote taken more than six months before a change could not qualify under the special regulatory rule even if no transfers of T stock occur after that vote until a date less than six months before the change, notwithstanding that if a record date had been established six months before the change, that record date would have shown the same shareholders as those who voted pursuant to the earlier record date. It can be argued that the special regulatory rule should be read more liberally in such circumstances, since the identical T shareholders who participated in the earlier vote (based on a more-than-six-months-before-change record date) would have participated in a later vote (based on a six-months-before-change record date), but we have only faint hope that the IRS or a court will embrace this more liberal reading.

Example 32

Same as Example 29, except that (1) T's shareholder vote occurs on January 1 year 3 based on a January 1 year 3 record date of T's shareholders (i.e., six months before T's June 30 year 3 change) and (2) on March 31 year 3 individual B, who owned 30 percent of T's stock, transfers that 30 percent to individual D, a person who was not previously a T shareholder.

The special regulatory rule applies regardless of how much T voting stock is transferred after the January 1 year 3 shareholder vote and before the June 30 year 3 change, since T's January 1 year 3 shareholder vote was "based on the shareholders of record as of any date [here January 1 year 3] within the six-month period immediately prior to and ending on [the June 30 year 3] date of the change," so long as there was adequate disclosure to shareholders, an issue discussed below.

Example 33

Same as Example 32, except that (1) T's shareholder vote occurs on December 15 year 2 based on T's shareholders of record on December 15 year 2 (i.e., 6½ months before T's June 30 year 3 change in ownership).

The special regulatory rule, read literally, does not apply because the December 15 year 2 vote was not based on T's shareholders of record as of a date within six months before the June 30 year 3 change.

See discussion above regarding the possibility of a more liberal reading.

Example 34

Same as Example 32 (T's shareholder vote occurs on January 1 year 3, within six months before the June 30 year 3 change), except that the January 1 year 3 vote is based on a December 29 year 2 record date for T's shareholders.

⁸⁵Reg. section 1.280G-1 Q&A 7(b)(2). The 2002 proposed regulations granted more limited relief, permitting the determination of eligible voters to be "based on the shareholders of record at the time of any shareholder vote taken in connection with a transaction or event giving rise to such change in ownership or control and within the three-month period ending on the date of the change in ownership or control, provided the adequate disclosure requirements" are met. 2002 prop. reg. section 1.280G-1 Q&A 7(b)(2).

The answer is the same as in Example 33 — the special regulatory rule, read literally, does not apply.⁸⁶

Example 35

Same as Example 29 (A enters into a contract on January 1 year 1 to receive a \$1 million payment in the event of a change in T's control with a shareholder vote on June 30 year 3), except that A did not agree to give up his right to the \$1 million payment if the shareholder vote requirement is not satisfied, so that A is entitled to receive and retain the payment without regard to the outcome of the vote.

Under the regulations, the shareholder vote does not satisfy the shareholder approval exception because the vote did not determine A's right to receive or retain the payment (i.e., A's right to receive and retain the payment was not contingent on satisfaction of the shareholder vote requirement).

Example 36

Same as Example 29 (i.e., employment contract with \$1 million change in control payment entered into January 1 year 1 with June 30 year 3 shareholder vote), except that (1) A's employment contract states that A will be entitled to the payment only if the shareholder vote exception is satisfied before any change in ownership and (2) on January 1 year 1 T's shareholders enter into a front-end voting trust or voting agreement requiring the shareholders and their transferees to vote in favor of the payment to A in any subsequent vote. On June 30 year 3, immediately before the change in ownership, T's shareholders unanimously vote in favor of making the payment.

We believe the shareholder approval exception should apply, although this conclusion is not free from doubt.

Example 37

Same as Example 32 (January 1 year 1 contract to make payment to A and January 1 year 3 shareholder vote under special regulatory rule), except that on May 31 year 3 (that is, prior to the June 30 year 3 change), T issues a class of publicly traded common stock with 24 percent of T's voting power.

⁸⁶The argument for a more liberal reading of the special regulatory rule is somewhat more taxpayer-sympathetic than in Example 33, because T's shareholder vote actually occurs within six months of the June 30 year 3 change and T's use of a December 31 year 2 record date instead of a January 1 year 3 record date (which would have produced an identical list of shareholders) for the January 1 year 3 shareholder vote can be viewed merely as meaningless administrative error.

Because some T stock is publicly traded immediately before the change, the shareholder approval exception does not apply, even though (1) the payment was unanimously approved by T's shareholders on January 1 year 3 when no T stock was publicly traded, (2) the determination of the shareholders entitled to vote was based on the shareholders of record as of January 1 year 3, a day within the six-month period ending on the change date, and (3) the approving shareholders continued to own more than 75 percent of T's voting stock.

In determining the group of eligible voters and in determining whether more than 75 percent shareholder approval has been obtained, T stock owned (or treated as owned under section 318(a)) by persons receiving payments that would but for the shareholder approval rule be parachute payments (or by certain related persons) is ignored, unless this rule would have the effect of ignoring all of T's outstanding voting stock.⁸⁷

To comply with the "adequate disclosure" requirement, (1) there must be "adequate disclosure . . . of all material facts concerning all material payments which (but for [the shareholder approval exception]) would be parachute payments with respect to a disqualified individual,"⁸⁸ (2) "[f]or each disqualified individual, [such disclosure must include, but is not limited to,] material facts [regarding] . . . the event triggering the payment or payments, the total amount of the payments that would be parachute payments [absent] shareholder approval . . . , and a brief description of each payment (e.g., accelerated vesting of options, bonus, or salary),"⁸⁹ (3) the disclosure must be made to "all persons eligible to vote,"⁹⁰ and (4) the disclosure must be made "before the vote."⁹¹

There is ambiguity as to the persons to whom adequate disclosure must be made when, after the shareholder vote but before the change, stock is transferred to a person who was not a shareholder at the time of the shareholder vote. Under the special regulatory rule, it seems reasonably clear that adequate disclosure to all shareholders of record on the record date (within six months before the change) is sufficient, and failure to give the new postvote shareholder adequate disclosure is not fatal. The regulations state that "a vote . . . does not fail [to satisfy the shareholder vote requirement] merely because the determination of shareholders entitled to vote . . . is based on the shareholders of record as of any day within the six-month period"

⁸⁷Reg. section 1.280G-1 Q&A 7(a)(4). See also 2002 prop. reg. section 1.280G-1 Q&A 7(a)(4); 1989 prop. reg. section 1.280G-1 Q&A 7(c).

⁸⁸Reg. section 1.280G-1 Q&A 7(a)(2). See also 1989 and 2002 prop. reg. section 1.280G-1 Q&A 7(a)(2).

⁸⁹Reg. section 1.280G-1 Q&A 7(c). See also 2002 prop. reg. section 1.280G-1 Q&A 7(c).

⁹⁰Reg. section 1.280G-1 Q&A 7(a)(2). See also 1989 and 2002 prop. reg. section 1.280G-1 Q&A 7(a)(2).

⁹¹Reg. section 1.280G-1 Q&A 7(a)(2). The 1989 and 2002 proposed regulations were silent regarding timing of required disclosure.

COMMENTARY / SPECIAL REPORT

before the change⁹² and adequate disclosure “must be made to every shareholder . . . entitled to vote.”⁹³ It seems clear from this language that “every shareholder . . . entitled to vote” (and hence entitled to disclosure) means every shareholder on the selected record date (within six months before the change).

However, where T is relying not on the special regulatory rule but on the general statutory rule for determining the shareholders eligible to vote (for example, because a front-end vote was held based on a record date more than six months before the changes), the answer is less clear. Section 280G(b)(5)(B) simply says the payment must be “approved by a vote of the persons who owned immediately before the change . . . more than 75 percent of the voting power” with adequate disclosure to shareholders. The regulations elaborate slightly, calling for approval “by more than 75 percent of the voting power of all outstanding stock . . . entitled to vote immediately before the change.”⁹⁴ And further regulatory language (the same regulatory language quoted above dealing with disclosure for the special regulatory rule applies to the general statutory shareholder vote exception) calls for adequate disclosure “to every shareholder . . . entitled to vote.”⁹⁵ So the question is whether the reference to “every shareholder . . . entitled to vote” means every shareholder when the vote actually took place or every shareholder who would have been entitled to vote if a shareholder vote had been taken immediately before the change.

As discussed earlier, we believe it is clear that the determination of whether 75 percent of T’s shareholders have voted favorably looks to whether the shareholders who voted favorably at a front-end vote still own more than 75 percent of T’s voting power immediately before the change. Perhaps consistency calls for a conclusion that adequate disclosure must be made to all shareholders who would have been entitled to vote if a vote had been held immediately before the change, in which case an acquisition of even one voting share by a person not a shareholder at the time of the actual front-end vote would prevent use of the general exception (since the regulations require the disclosure to be made “before the vote”).⁹⁶ On the other hand, for the special regulatory rule, the regulations (as stated above) clearly call for adequate disclosure only to shareholders at the time of the actual vote, not additional shareholders at the time of a hypothetical vote immediately before a change, suggesting that the regulations regarding the general rule might not be read as requiring disclosure to all shareholders immediately before the change.

The correct interpretation is not free from doubt.

Under either the general statutory exception or the special regulatory rule, transfers (after the vote and before the change) from one shareholder to another

person who was a shareholder at the time of the vote and hence received adequate disclosure before the vote do not create a disclosure issue.

Example 38

Same as Example 30 (i.e., unanimous January 1 year 1 front-end shareholder vote, with prior adequate disclosure to January 1 year 1 shareholders) and on March 31 year 3 less than 25 percent of T’s outstanding voting stock is transferred to D, a person who was not a T shareholder at the time of the front-end vote).

It is not clear whether the shareholder vote exception’s adequate disclosure requirement is violated by T’s failure to make adequate disclosure to D (the new less-than-25-percent postvote shareholder) “before” the January 1 year 1 vote occurred.

If this issue is resolved in a pro-taxpayer fashion, there still remains the additional disclosure issue discussed in Example 41 below as to whether T’s failure to disclose to all of its shareholders (at the time of the January 1 year 1 vote) facts not yet known to T destroys the adequacy of T’s prevote disclosure.

Example 39

Same as Example 32 (i.e., unanimous January 1 year 3 shareholder vote with 30 percent of T’s voting stock transferred to D, a person who was not previously a T shareholder, after the January 1 year 3 shareholder vote and before the June 30 year 3 change).

The special regulatory rule’s adequate disclosure requirement does not appear to be violated, since the special rule clearly requires prevote disclosure only to persons who are shareholders on the less-than-six-months-before-change record date.

If this issue is resolved in a pro-taxpayer fashion, there still remains the additional disclosure issue discussed in Example 41 below as to whether T’s failure to disclose to all of its shareholders (at the time of the January 1 year 3 vote) facts not yet known to T destroys the adequacy of T’s prevote disclosure.

Example 40

Same as Example 32 (T’s January 1 year 3 shareholder vote meets the special regulatory rule), except that on March 31 year 3, three months after the shareholder vote on the \$1 million payment, T, without seeking any further shareholder approval or making any disclosure to shareholders, agrees to accelerate vesting of a significant number of A’s stock options in the event of a change in T’s ownership.

It appears that the shareholder approval exception does not apply to either payment to A. With respect to the payment resulting from accelerated

⁹²Reg. section 1.280G-1 Q&A 7(b)(2).

⁹³Reg. section 1.280G-1 Q&A 7(c).

⁹⁴Reg. section 1.280G-1 Q&A 7(a)(1).

⁹⁵Reg. section 1.280G-1 Q&A 7(c).

⁹⁶Reg. section 1.280G-1 Q&A 7(a)(2).

vesting of A's stock options, no shareholder approval occurred. With respect to the \$1 million original payment, T's failure to disclose the March 31 year 3 stock option acceleration prior to the January 1 year 3 shareholder approval of the \$1 million payment would appear to violate the adequate disclosure requirement, even though the accelerated stock option vesting was not agreed on until three months after the shareholder vote on the \$1 million payment.

Example 41

Same as Example 30 (front-end shareholder vote on January 1 year 1 just before signing contract with A) or Example 32 (January 1 year 1 contract with A and shareholder vote on January 1 year 3), except that under the contract the amount of A's payment varies with the price paid to T's shareholders in the change transaction. T discloses to all shareholders (in advance of the January 1 year 1 or January 1 year 3 vote) all material facts then known to T, including (1) T's obligation to make payments to A on a change and (2) the formula for calculating A's payment. However, T is not able to disclose to shareholders in advance of the vote (because T does not then know) (1) "the event triggering the payment" (which turns out to be P's purchase of all T's stock on June 30 year 3) or (2) "the total amount of the [potential parachute] payments."

If the facts not disclosed before the shareholder vote (e.g., who would acquire T, the method of acquisition, the price to be paid for T, and the actual amount to be paid to A under the contractual formula) are "material" (i.e., "there is a substantial likelihood that a reasonable shareholder would consider [such facts] important"⁹⁷), after taking into account all the facts actually disclosed before the vote, then the shareholder vote exception (either the general statutory exception or the special regulatory rule) apparently does not apply.

Whether the facts not disclosed are "material" is a factual question.

Several other points should be noted in connection with the 75 percent shareholder vote exception:

(1) The members of an affiliated group are treated as a single corporation. Accordingly, the exception is not available if the stock of any member of the group is publicly traded. If the exception is available, the 75 percent approval presumably should be given by the shareholders of the parent corporation. It is unclear, however, how the rules operate when a portion of the stock of one or more of the subsidiary members of the group is owned by unrelated persons.

⁹⁷Reg. section 1.280G-1 Q&A 7(c). See also 2002 prop. reg. section 1.280G-1 Q&A 7(c); 1989 prop. reg. section 1.280G-1 Q&A 7(d).

(2) In determining whether any T stock is publicly traded, T preferred stock described in section 1504(a)(4) is ignored, so long as the payment to disqualified individuals "does not adversely affect the redemption and liquidation rights of any shareholder owning such stock."⁹⁸

(3) Where T stock is owned (directly or indirectly) by a person other than an individual (that is, by an entity) and the T stock comprises at least one-third of such entity shareholder's gross assets: (a) a vote of the entity shareholder's stock must be made by the entity shareholder's owners who hold more than 75 percent of the voting power with respect to the entity shareholder's management issues, rather than by the entity shareholder itself, unless the entity shareholder owns 1 percent or less of T's stock (by value), and (b) if the entity shareholder is publicly traded, the shareholder approval exception is unavailable to T (even if the entity shareholder owns less than 1 percent of T's stock).

If any equity interest in the entity shareholder is owned by a person receiving payments that would (but for the shareholder approval rule) be parachute payments, or by certain related persons (a tainted holder), special rules apply. First, to the extent T stock owned by the entity shareholder is attributed to a tainted holder under section 318(a), that T stock is ignored for purposes of the shareholder approval rule, unless this would have the effect of ignoring all of T's outstanding voting stock.⁹⁹ Second, if the person authorized to vote the stock of an entity shareholder is a tainted holder, "such person is not permitted to vote such shares, but the entity shareholder is permitted to appoint an equity interest holder in the entity shareholder . . . to vote the otherwise eligible shares."¹⁰⁰

(4) If T obtains 75 percent shareholder approval for a *portion* of a payment, that portion is exempt from the golden parachute rules. For example, if executive A, with a \$300,000 base amount, is to receive \$1 million of payments that would (absent 75 percent shareholder approval) constitute parachute payments, but T obtains 75 percent shareholder approval for payments aggregating \$101,000, the unapproved payments (\$899,000) would fall short of the three-times-base-amount threshold and hence the golden parachute sanctions would be avoided.

⁹⁸Section 280G(b)(5)(A).

⁹⁹Reg. section 1.280G-1 Q&A 7(b)(4). See also 2002 prop. reg. section 1.280G-1 Q&A 7(b)(4); 1989 prop. reg. section 1.280G-1 Q&A 7(c).

¹⁰⁰Reg. section 1.280G-1 Q&A 7(b)(4). See also 2002 prop. reg. section 1.280G-1 Q&A 7(b)(4) (containing rules similar to the first and second special rules, but not permitting substitution of another equity interest holder for a tainted holder); 1989 prop. reg. section 1.280G-1 Q&A 7(c) (containing rules similar to the first special rule, but not the second).

(5) The 75 percent shareholder vote can be either a single vote covering the payments to a group of disqualified individuals or a series of separate votes each covering payments to a disqualified individual.

(6) The regulations state that the 75 percent shareholder approval exception does not apply "if approval of the change in [T's] ownership or control [e.g., P's acquisition of T] is contingent, or otherwise conditioned, on [the 75 percent shareholder] approval of any payment" to a T executive.¹⁰¹ Accordingly, when the shareholder resolution to approve the merger, sale of assets, or other change transaction states that the shareholder vote approving the change transaction either (a) also constitutes approval of parachute payments to T executives or (b) is nullified if there is not also a 75 percent vote to approve the parachute payments, the 75 percent shareholder vote on the parachute payments does not achieve the desired goal of creating an exemption from the section 280G rules.

The shareholder approval exception should, however, be available when the P-T acquisition documents condition closing on the absence of any parachute payments. In this case, if shareholder approval is sought (and the shareholder vote determines the right of all T executives to receive or retain any payments that would be parachute payments absent shareholder approval), either (a) the shareholder vote will be favorable (and the payments will be made but not treated as parachute payments) or (b) the shareholder vote will be unfavorable (and the payments will not be made).¹⁰²

It is less clear whether the 75 percent shareholder approval exception is available if, as is often the case, the P-T acquisition documents allow P to abort the transaction if T's shareholders fail to satisfy the 75 percent shareholder approval exception (for example, the acquisition agreement grants P a closing condition so that P can choose to (a) abort the acquisition if T shareholder approval is not obtained or (b) waive the closing condition and complete the acquisition).

(7) The statute requires approval "by a vote of the persons who owned . . . more than 75 percent of" T's voting power. Although not explicit, it appears that shareholder action by written consent would satisfy this requirement when, under state law and T's charter, written consent is as effective as a vote, so long as (a) 100 percent of T's shareholders so consent (as required in some states for shareholder action by written consent) or (b) when state law allows action by consent of less than all shareholders, more than 75 percent consent.

(8) A 2001 private ruling concluded that a corporation in bankruptcy had satisfied the 75 percent shareholder approval exception when (a) the corporation's stock (which had previously traded on a stock exchange) was delisted after the corporation filed for bankruptcy, so that the stock was no longer publicly traded and (b) the bankruptcy court had approved the reorganization plan (providing for parachute payments), thus constituting "shareholder" approval "because the creditors' committee and the bankruptcy judge represented the shareholders' interests and the shareholders were not otherwise eligible to approve the payments."¹⁰³

B. Friendly Acquisition

According to the 1984 Senate Report, the golden parachute provisions were enacted principally to deal with contested takeovers. In such an unfriendly takeover, T may enter into a contract to pay its executives substantial amounts in anticipation of hostile P winning control of T.¹⁰⁴ Congress adopted the golden parachute legislation to discourage such payments.

However, the statute as drafted goes further, covering (except to the extent (1) exempted by the overcomplicated 75 percent shareholder approval rule for a nonpublicly traded corporation as described in part VII.A or (2) paid by an SCo-eligible company as described in part VII.A or (3) treated as reasonable compensation for services rendered *after* the change in ownership):

(a) Payments arising out of P's friendly acquisition of T in a negotiated transaction when payments to T's executives (by T or P) are contingent on the acquisition's consummation; and

(b) Payments to T's executives that are not pursuant to preexisting contracts between T and its executives, but result from new contracts with T's executives requested by P, entered into before T's change in ownership, and designed to encourage T's executives to remain in T's employ after P's friendly acquisition of T.

Also, the 1984 Blue Book states that Congress sought to discourage golden parachute agreements in the context of friendly takeovers because "such arrangements tended to encourage the executives and other key personnel involved to favor a proposed takeover that might not be in the best interests of the shareholders or others."¹⁰⁵

VIII. Economic Effect of Section 280G

Golden parachute contracts may impose substantial cost (the amount paid to T's executives) on P when P acquires T in either an unfriendly or friendly takeover. Hence, when P knows about the contracts, P may well

¹⁰¹Reg. section 1.280G-1 Q&A 7(b)(1). See also 2002 prop. reg. section 1.280G-1 Q&A 7(b)(1).

¹⁰²Reg. section 1.280G-1 Q&A 7(e), example (2)(iii).

¹⁰³LTR 200212013, Doc 2002-7073 (6 original pages), 2002 TNT 57-31.

¹⁰⁴S. Rep. No. 169, 98th Cong., 2d Sess. 195 (1984).

¹⁰⁵1984 Blue Book at 199.

pay less to T's shareholders than if there were no golden parachute contracts.

To the extent the amounts paid to T executives constitute excess parachute payments, section 280G compounds the economic problem. By denying T a tax deduction for the excess parachute payments, T's after-tax cost for the payments is greater, and hence — when P knows about the contracts and their tax effect — P may well pay even less to T's shareholders.

To the extent the amounts paid to T executives constitute excess parachute payments, section 280G compounds the economic problem.

On the other hand, if the golden parachute rules actually discourage a generous golden parachute contract — as Congress contemplated they would — and as a result P is willing to pay more for T, T's shareholders benefit.

Example 42

Public T has 1 million shares outstanding, trading at \$75 per share (aggregate \$75 million). The net FV of T's assets is \$100 million. Because T is a takeover candidate, T's CEO, A, becomes concerned about his future and demands that T agree to pay him \$1 million (grossed-up for (1) the 20 percent golden parachute excise tax on the \$1 million payment and (2) federal and state income taxes (at an assumed 50 percent individual rate) and golden parachute excise taxes (on the gross-up payment) if A loses his job because of a takeover. A's base amount is \$300,000. Accordingly, T and A enter into a golden parachute agreement pursuant to which A is to receive \$1,466,667 in the event A loses his job as a result of T's takeover. A will thus receive \$1 million net of the additional taxes resulting from application of the golden parachute rules (\$1,466,667 payment to A less [(\$1,466,667 payment to A - \$300,000 base amount) x 20 percent] less [\$466,667 gross-up payment x 50 percent individual federal and state income tax] = \$1 million).

P wishes to acquire 100 percent of T's stock for \$100 million (\$100 per share), a \$25 million premium over the \$75 million aggregate price at which T's shares are trading. On learning of the golden parachute agreement between T and A, P reduces the amount it is willing to pay by \$1,346,667, the after-tax cost to T of a \$1,466,667 payment to A under the golden parachute agreement (\$1,466,667 payment to A less \$120,000 T-level tax savings (40 percent corporate-level federal and state tax rate x \$300,000)). Accordingly, P offers T's shareholders only \$98.65 per share

[((\$100 million less \$1,346,667) divided by 1 million shares].

Example 43

Same as Example 42, except that T is privately held and more than 75 percent of T's shareholders (by voting power), after adequate disclosure, approve the parachute agreement with A.

T can satisfy A's request with an agreement to pay A \$1 million rather than \$1,466,667 (because A is not subject to a 20 percent excise tax on any portion of that payment). Further, P's after-tax cost for the payment to A is only \$600,000 (assuming no unreasonable compensation problem and a 40 percent corporate-level federal and state tax rate), because the \$1 million payment to A is fully deductible. Accordingly, P is willing to offer each T shareholder \$99.40 per share [(\$100 million - \$600,000) divided by 1 million shares].

As these two examples demonstrate, where the golden parachute tax provisions do not discourage T from adopting a golden parachute for A, the golden parachute tax can have the unfortunate effect of increasing the cost to P and T, and hence reducing the amount per share paid to T's shareholders, that is, from \$99.40 per share in Example 43 (when private T was able to opt out of the golden parachute tax) to \$98.65 per share in Example 42 (when public T was not allowed to opt out of the tax).

IX. Conclusion

What sensible function in our tax law do the golden parachute penalty tax provisions perform? Surely they do not really suppress greed, protect shareholders from rapacious executives, appropriately raise revenue, or improve the coherence of the tax system in which they play an ill-suited part. But to grumble excessively is foolish, for without question these foolish, burdensome, incoherent provisions have great value. They are marvelously productive of legal fees.

Speaking not of tax law — as today he surely would — Charles Dickens in *Bleak House* said it wonderfully:

The one great principle of English law [read instead "U.S. tax law"] is to make business for itself. There is no other principle distinctly, certainly, and consistently maintained through all its narrow turnings. Viewed by this light it becomes a coherent scheme and not the monstrous maize the laity are apt to think it. Let them but once clearly perceive that its grand principle is to make business for itself at their expense, and surely they will cease to grumble.

The next time you hear a member of Congress deplore the American tax system's excessive complexity, resolve to do all you can to throw the rascal out.