Welcome!

Golden Parachute Tax Terror

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Golden Parachute Rules

- Section 4999 imposes a 20% excise tax on the recipient of excess parachute payments
- Section 280G prohibits the company that pays excess parachute payments from taking a deduction for such payments
- Designed to discourage a perceived abuse - excessive payments made to executives in connection with a change in ownership of the company

Golden Parachute Rules cont.

- Apply to entities taxed as C corporations
- Apply to compensatory payments to certain employees and/or independent contractors ("Disqualified Individuals") that are contingent upon a change in control ("Parachute Payments")

Analysis

1. Identify Disqualified Individuals (“DQIs”)
2. Determine the “Base Amount” for each Disqualified Individual
3. Identify and value all Parachute Payments to be made to each Disqualified Individual

1. Identify Disqualified Individuals

- Employees and Independent Contractors who are (or were at any time during the 12 month period that ends on the date of the Change in Control transaction) also an:
  1. Officer,
  2. Shareholder, or
  3. Highly Compensated Individual

Officers

- Whether a person is an officer or not is a facts and circumstances test.
- Anyone with an officer title is presumed to be an officer.
- The number of officers that are DQIs is limited to the lesser of:
  - 50; or
  - the greater of: 3 or 10% of the employees (using highest number of employees that the corporation had at any time during the 12 month period ending on the date of the Change in Control transaction).
- If not all officers must be counted, then the lowest paid officers are eliminated first.

Shareholders

- Only service providers who own stock with at least 1% of the fair market value of all outstanding shares
- All vested options are counted as outstanding shares
- All unvested options that will vest upon the contemplated change in control transaction are counted as outstanding shares
- Shares and options owned by the service provider's family members are counted as owned by the service provider

Highly Compensated Individuals

- Annual compensation of at least $120,000 (in 2016), and
- In group of the lesser of:
  - Highest paid 1%, or
  - Highest paid 250 service providers
  - Ranked on basis of amounts paid during 12 months prior to Change in Control
- Highest paid 1% is 1% of greatest number of employees the corporation had during the 12 months prior to the Change in Control

2. Determine Base Amount for each DQI

- Base Amount = average of total annual compensation paid to a DQI by the corporation (or a predecessor corporation) in each of the five calendar years preceding the year in which the Change in Control transaction occurs.

Base Amount Example 1

- DQI #1 has been employed by Corporation since 2009. Corporation anticipates a Change in Control transaction to close in 2016. DQI #1's W-2s indicate the following amounts:

2015	245,000
2014	225,000
2013	200,000
2012	175,000
2011	150,000
Total	995,000 / 5 = $199,000 Base Amount

Base Amount Example 2

- DQI #2 has been employed by Corporation since July 1, 2013. Accordingly, his 2012 compensation must be annualized:

2015		245,000
2014		225,000
2013		215,000
2012	100,000	200,000
Total		885,000 / 4 = $221,250 Base Amount

Excess Parachute Payment Threshold

- Excess Parachute Payment Threshold = 3 x Base Amount:
  - DQI #1's Base Amount = 199,000 x 3 = $597,000
  - DQI #2's Base Amount = 221,250 x 3 = $663,750
- If DQI #1's total Parachute Payments < $597,000 – no problem
- If DQI #1's total Parachute Payments ≥ $597,000 – all amounts received in excess of $199,000 are subject to 20% excise tax and deduction disallowance.

Terror of Falling Off the 280G Tax Cliff

- DQI #1 in prior example is entitled to receive a transaction bonus upon a Change in Control transaction, which is the only Parachute Payment to which he is entitled:
  - If the bonus is $595,000 – it is exempt from 280G and 4999
  - If the bonus is $600,000 – then $401,000 is subject to the 20% excise tax (which will cost DQI $80,200) and Corporation is not allowed to deduct $401,000 it paid to DQI #1

3. Identify and Value Parachute Payments Examples of Parachute Payments:

- Bonuses (Transaction, Retention, etc.)
- Severance Payments & Continuation of Benefits
- Outplacement Benefits
- Equity Incentive Grants (Options, Restricted Stock, etc.)
- Phantom Equity Awards
- Increases in Compensation
- Acceleration of Vesting

Grants, Awards, Amendments, etc. made within 12 months of Change in Control are presumed to be contingent upon a Change in Control.

Valuation Example: Stock Options

- Acceleration of Vesting upon a Change in Control must be valued and included in a DQI's total Parachute Payments.
- Fact Pattern:
  - DQI works for Corporation, which anticipates a sale of 100% of Corporation's stock to Buyer on June 30, 2016 for $100 per share. DQI received an Option Grant to purchase 300 shares on January 1, 2014, with an exercise price of $50 per share and 1/3 of which vests on each of the first, second and third anniversaries of the grant. DQI also received a second Option Grant to purchase an additional 200 shares on January 1, 2016 with an exercise price of $85 per share and 1/3 of which vest on each of the first, second and third anniversaries of the grant.

Valuation Example cont. First Grant

- 200 vested, 100 unvested will vest upon Change in Control
- FMV = $50 [$100 sales price – $50 exercise price]

$50 x 100 shares:	$5000.00	
Present Value:	<u>$4973.30</u>	
Difference:	$26.70	= Value of Acceleration
$50 x 6 months x 1%:	<u>$300.00</u>	= Value of Time Lapse
	$326.70	= Value of Vesting

- Acceleration for 100 unvested options from First Grant to be included in DQI's total Parachute Payments.

Valuation Example cont. Second Grant

- Granted during the 12 months preceding the Change in Control – presumed to be contingent upon a Change in Control
- FMV = $15 [$100 sales price – $85 exercise price]

  $15 x 200 = $3000

- Full value of 200 options from Second Grant to be included in DQI's total Change in Control payments.

Parachute Payment Exceptions

- Certain payments from qualified plans
- Payments that may be established by "clear and convincing evidence" to be "reasonable compensation" for services
- Shareholder Approval Exception (available only to non-publicly held corporations)

Shareholder Approval Exception Requirements

- Approval of 75% of all shareholders entitled to vote, which vote must determine the right of the DQI to receive (or keep) the payment, which requires a waiver by DQI of the right to receive the payment if not approved.
- In advance of the shareholder vote, each shareholder entitled to vote, must first be provided "Adequate Disclosure" of all material facts concerning all material would-be parachute payments

Lessons

- Failing to be aware of the implications of 280G and 4999 can be a very expensive oversight.
- Doing a Parachute Payment Analysis takes some time and effort. Accordingly, corporations anticipating a Change in Control transaction should be pro active about doing a Parachute Payment analysis well in advance of the transaction closing.

Thank you for attending today's Tax Law webinar

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