280G Outline

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Part 1: The Fundamentals

What is a Change in Control ("CIC") for Purposes of IRC Section 280G?

In general, the 280G regulations provide that a CIC occurs when:

– An acquisition of more than 50 percent of the total fair market value or total voting power of the acquired company's stock has occurred.

• A presumed CIC may occur when:

• Any one person, or more than one person acting as a group, acquires more than 20% of the voting power of the stock of such corporation in a
12-month period.

• A majority of members of the corporation’s board of directors is replaced during any 12-month period.

• A presumed CIC may be rebutted if the company can establish that such actions do not transfer the power to control (directly or indirectly) the management and policies of the corporation from any one person to another.

– During a 12-month period, the sale of a substantial portion of the fair market value of the corporation’s assets (defined as one-third).

– Also see Regulations Section 1.280G-1 Q/A 27-29.

What Types of Entities Affected by 280G?

– Publically Traded Corporations

– Non-Public Corporations

– Exemption Available IF Shareholder Approval is Obtained

• See Treasury Regulations Section 1.280G-1 Q/A 7 for details on obtaining a shareholder approval vote.

• Be advised: Shareholder approval votes are complex, and require a careful understanding of the rules.

– Small Business Corporations (as defined in IRC Section 1361) “S-Corps” are not subject to Section 280G.

– In general, Tax-Exempt Organizations are not subject to Section 280G.

– Also see Treasury Regulations 1.280G-1 Q/A 6 for details regarding entities affected by IRC 280G.

Which Employees/Executives/Owners are Subject to 280G?

– A person who is subject to IRC Section 280G is referred to in the Regulations as a “Disqualified Individual” (“DI”)

– A DI can be a:

• A shareholder

– Shareholders who own more than 1% of the fair market value of the outstanding shares of all classes of the corporation’s stock

– Attribution rules under IRC Section 318(a) apply

– Also see Regulations 1.280G-1 Q/A 17

• An Officer

– Determination of who is an officer is based on all the facts and circumstances of a particular case. Factors include source of individual's authorities, the term elected, nature of duties, title (unless duties do not commensurate with title).

– No more than 50 employees. If less than 50, the greater of 3 employees or 10 percent of the employees of the corporation (rounded up).

– Also see Regulations 1.280G-1 Q/A 18.

• A Highly Compensated Individual

– Among the highest 1% of employees rounded up to the nearest whole number, or

– The top 250 employees (if total # of employees is greater than 25,000)

– For purposes of computing total employees, an employee who works less than 17.5 hours per week is not an "employee" for purposes of this computation.

– An employee who works less than 17.5 hours per week MAY STILL be considered as a DI.

– However, no individual whose annualized compensation is less than the amount described in section 414(q)(1)(B)(i) will be treated as a highly-compensated individual. (Currently $110,000)

• Also see Regulations 1.280G-1 Q/A 19.

The 280G Base Amount & Safe Harbor Threshold

– In order to determine whether an executive receives a parachute payment for IRC section 280G purposes, the first step is to determine the 280G Safe Harbor Amount.

– Base Amount

• A DI's base amount is equal to the average annual compensation for services performed that would have been includible in gross income for the five taxable years preceding the change in control.

– In most cases, this amount is commensurate with Box 1 of the DI's Form W-2.

• If the base period of a disqualified individual includes a short taxable year, or less than all of a taxable year, compensation for such short or incomplete taxable year must be annualized.

– Non-recurring payments are not annualized.

• For example: Assume in 2008 a DI works 183 days, Box 1 of DI's 2008 W-2 is $300,000, and part of this amount includes a $50,000 "sign on bonus" and $50,000 as a "relocation bonus". Because the sign-on and relocation bonuses are non-recurring payments only $200,000 of the $300,000 is annualized (i.e. [($300,000 - $100,000)/ (183/366)] = $400,000. The non-recurring bonuses are then added to the annualized amount to compute the base amount for that year: $400,000 + $100,000 = $500,000.

• If a DI is employed less than 5 years, annual compensation for services performed is based on the period the DI was employed.

– For example, if a CIC occurred on 12/31/2009, any part of the 2004-2008 period would be included.

• Also see Regulations Section 1.280G-1 Q/A 34.

– Three Times Base Test

• If the aggregate present value of payments received in connection with a CIC (Discussed on the next page) equals or exceeds the amount equal to 3 times DI's base amount, the payments are parachute payments.

• The term "280G Safe Harbor" is often used in employment/CIC agreements. The "280G Safe Harbor Amount" is technically one dollar less than three times the DI's base amount.

• Also see Regulations Section 1.280G-1 Q/A 30.

What is a "Parachute Payment" for 280G Purposes?

– If the aggregate present value of payments received in connection with a CIC equals or exceeds 3 times the DI's base amount, the payments are
parachute payments.

– In general, a parachute payment is any payment(s) contingent on or in anticipation of a CIC. Common payments include:

• Severance

• Deal bonuses

• Health & welfare benefits

• Perquisites

• Unvested payments (such as options, stock awards, long term incentive plans, or other retirement plans) which become accelerated upon a CIC

• Additional pension credits

• Pro-rated annual bonuses

– A parachute payment is generally a payment which would not, in fact, have been made in the absence of a change in ownership or control unless it is substantially certain, at the time of the change that the payment would have been made whether or not the change occurred.

• Also see Regulations Sections 1.280G-1 Q/A 2 & Q/A 22.

– A payment is presumed to be contingent on a CIC if the payment is entered into within one year of the CIC.

• Also see Regulations Section 1.280G-1 Q/A 26.

– If an agreement is modified within one year of a CIC, then any payment made pursuant to a modification made within one year of the CIC would be presumed to be contingent upon a CIC. This presumption may be rebutted if:

• The taxpayer establishes by clear and convincing evidence that the payment is not contingent on the CIC.

• This analysis is a facts and circumstances analysis; the key questions to ask are whether the right to the payment was established at a time when a takeover attempt had commenced and the degree of likelihood that a change in ownership or control would actually occur.

• Examples of payments made within a year of a CIC that would be excluded are:

– A nondiscriminatory employee plan or program.

– An arrangement that replaces a prior arrangement entered into by the same parties more than one year before the CIC if the new arrangement does not provide for increased payments (apart from normal increases attributable to increased responsibilities or COLA).

– An arrangement entered into with respect to a DI who was hired in the year of the CIC, provided the contract does not provide for payments that are significantly different in amount, timing, terms, or conditions from those provided under contracts entered into by the corporation with individuals performing comparable services.

• Also see Regulations Section 1.280G-1 Q/A 26.

Computation of the 280G Excise Tax & Determining which Parachute Payments are Non-Deductible

– Section 280G disallows a deduction for any excess parachute payment paid or accrued.

– IRC Section 4999 imposes on any person who receives an excess parachute payment a tax equal to 20 percent of the amount of such payment.

– The term "excess parachute payment" means an amount equal to the excess of any parachute payment over the portion of the base amount allocated to such payment.

• In general, the total amount of excise tax is equal to the gross value of the parachute payments less one times base amount.

• For purposes of determining the three times base test the present value of all the parachute payments are used. However, for purposes of computing the excise tax, the full parachute value is used.

• Also see IRC Section 4999 and Treasury Regulation Section 1.280G-1 Q/A 3.

– Example: On 1/1/X1 a CIC occurs, and in accordance with the terms of the agreement, DI receives a CIC severance payment of $3,075,000 where 1/36th of this amount will be paid on the 15th of every month starting 1/15/X1. The present value of this severance payment is determined on the CIC to be $3,000,000. DI's average taxable income for the 5 years preceding the CIC is $900,000.

• DI exceeds the three times base threshold amount by $300,001.

– ($3,000,000 – (3*900,000) -1)

• In order to determine the DI's excise tax obligation, the base amount of 900,000 is allocated to the payments made. This amount is referred in the regulations as "Excess parachute payments".

– Year x1 = $1,025,000 – 300,000 = $725,000

– Year x2 = $1,025,000 – 300,000 = $725,000

– Year x3 = $1,025,000 – 300,000 = $725,000

• The total Excise tax for each year equals $145,000

– (20% * $725,000) = $145,000; Total Excise Tax over three years $435,000

• Total Non-Deductible Payments = $725,000 per year; Total Non-Deductible payment equals $2,175,000.

Part 2: Some Finer Points

How to Determine the Present Value of a Payment?

– The present value of a payment is determined as of the CIC, or, if a payment is made prior to such date, the date on which the payment is made.

– Present value generally is determined by using a discount rate equal to 120 percent of the applicable Federal rate compounded semiannually.

– The applicable Federal rate to be used for this purpose is the Federal rate that is in effect on the date as of which the present value is determined. Using the period until the payment would have been made without regard to the CIC.

– Also see Treasury Regulation Section 1.280G-1 Q/A 31-33.

How to Value an Unvested Payment

– If upon a CIC a non-vested payment becomes vested, and absent a CIC the payment would have vested if only on the continued performance of services for the corporation for a specified period, then the full value of the payment is not included as a parachute payment.

– The Regulations provide for a special computation, where only the present value of receiving the payment early AND a lapse of obligation factor is included.

• The lapse of obligation factor is 1% of the amount of the accelerated payment multiplied by the number of full months between the date the DI had a right to the payment absent the date the payment was actually made (usually the CIC date).

• Also see Treasury Regulation Section 1.280G-1 Q/A 24(c).

– Note that this method of computation does not apply where an executive receives additional years of service for purposes of computing a SERP benefit.

• The entire portion of the SERP relating to the additional years of service is a 280G payment.

• Also see Treasury Regulation Section 1.280G-1 Q/A 24(f).

– On June 5, 20X7 DI received an award for 40,000 stock options with an exercise price of $10 per share. Pursuant to the terms of the stock option plan and award agreement if DI remains employed with company, his/her options would vest annually in increments of 25% starting June

5, 20X8. On August 11, 20X9, Company undergoes a CIC with a deal price of $25 per share. Pursuant to the stock plan, DI becomes vested with respect to the entire award and will be cashed out.

– Step 1: What is the gross value of the unvested payment?

• Under the plan, 20,000 of the 40,000 stock options are unvested, thus the value of the unvested payment is 20,000 * $15 (i.e. $25 - $10) = $300,000 (i.e. 150,000 for each tranche).

– Step 2: What is the total number of full months of accelerated vesting?

• For the tranche which vests on June 5, 20X10, there are 9 full months (Sept – May) between the CIC vesting date and normal vesting. For the Tranche which vests on June 5, 20X11, there are 21 full months between the CIC vesting date and normal vesting.

– Step 3: Compute lapse of obligation factor:

• For tranche #1 the value is 9% * $150,000 = $13,500

• For tranche #2 the value is 21% * $150,000 = $31,500

• Total lapse of obligation factor is $45,000

– Step 4: Compute the present value of receiving payment early

• For tranche #1 we compute the PV of $150,000, assuming a semi-annual compounding 120% AFR Rate (1% in August 09) base on an acceleration of payment between 6/6/2010 and 8/11/2009 to be $1,217.

• For tranche #2 we assumed this amount to be $2,693.

• Thus the present value portion of the payment is $3,910

– Step 5: Add lapse obligation and present value components

• Total parachute payment for this payment is $48,910 (as opposed to $300,000).

How to Value a Stock Option

– If a stock option is “rolled over” rather than cashed out upon a CIC, you may not simply use the intrinsic value of the stock option
(i.e. deal price less exercise price).

– The value of an option at the time the option vests are determined under all the facts and circumstances in the particular case. Factors relevant to such a determination include, but are not limited to:

• The difference between the option's exercise price and the value of the property subject to the option at the time of vesting;

• The probability of the value of such property increasing or decreasing; and

• The length of the period during which the option can be exercised.

– See Treasury Regulation Section 1.280G-1 Q/A 13

– Revenue Procedure 2003-68 provides more details on how to value stock options.

• The Revenue Procedure provides for a “Valuation Safe Harbor”. This method is based on the Black-Scholes Model, and is in tabular form.

• The Revenue Procedure also permits the use of a GAAP approved option valuation model, such as Black-Scholes or Binomial (e.g. FAS 123R).

• “The value of a stock option will not be considered properly determined if the option is valued solely by reference to the spread between the exercise price of the option and the value of the stock at the time of the change in ownership or control.”

Part 3: Common Planning Techniques

Non-Competition Payments: Reasonable Compensation for Post Change-in-Control Services

– Under the golden parachute rules, if an executive receives compensation for the performance of services rendered after a CIC and such compensation is determined to be reasonable, the amounts paid in exchange for these services are exempt from the 280G excise tax.

• This includes bona fide non-competition arrangements.

• Also see Treasury Regulations Q/A11, 40, and 42.

– When valuing non-competition arrangements for 280G purposes, the valuation experts should consider the following:

• Whether in the absence of the covenant the covenantor would desire to compete with the covenantee;

• The ability of the covenantor to compete effectively with the covenantee in the activity in question;

• The feasibility, in view of the activity and market in question, of effective competition by the covenantor within the time and area specified in the covenant;

– Also see Revenue Ruling 77-403

• The annual compensation customarily paid by the employer or by comparable employers to persons performing comparable services.

• Thus, the value that may be ascribed to a non-competition agreement is limited to the lesser of the amount of economic loss that could be caused by the executive if he/she were to compete or the level of reasonable compensation for substantially similar services the executive could have earned during the restricted period.

– Typically these valuations are performed by valuation experts. When engaging a firm, you should ensure they understand that for purposes of IRC section 280G a reasonable compensation analysis be included.

– Where a DI enters into a new consulting/employment arrangement, it is also important to consider whether the arrangement and post-CIC compensation is reasonable compensation for post CIC-services. In this situation, however, only a reasonable compensation analysis would be required.

– See article by Laurence Wagman Journal of Compensation and Benefits September/October (2009) Vol. 25, No. 5, entitled "Structuring Change in Control Arrangements in the Current Financial Environment".

Reasonable Compensation for Pre-Change In Control Service

– If a DI is in an excess parachute payment situation, he/she may mitigate (not eliminate) his/her excise tax and the company's lost deduction if he/she can argue that a payment being made was reasonable compensation for pre change-in-control services.

– Unlike post-CIC services, these payments are still included for purposes of determining the three times base test.

– The DI can reduce the amount of excess parachute payments by the reasonable compensation for pre-CIC services.

• To make things more complicated the rules require that a percentage of the "one times base amount" that is allocated to this payment is added back. Thus, the DI gets a partial but not full benefit for the portion of the payment that is allocable to pre-CIC services.

• Examples of pre-CIC services are a pro-rated bonus, and a pro-rated payout on performance vested equity based on interim performance goals
being reached.

• See Treasury Regulations Q/A 39.

– Example #1: Assume upon a CIC that Executive A has a base amount of $600,000 and receives a $500,000 severance payment and $2,000,000 worth of unvested performance equity. The $2,000,000 of vesting was based on the executive having worked for two out of the three year performance period. The award agreement does not establish a payout schedule for interim pro-rated performance hurdles. In this example, $1,900,000 of the $2,500,000 payment would likely be subject to the 20% 280G excise tax (i.e. excise tax due of $380,000) because the company could not show by clear and convincing evidence that the payout was reasonable compensation for pre-change in control services.

– Example #2: Assume the same facts in Example 1, except that Executive A can demonstrate by clear and convincing evidence that the $2,000,000 worth of unvested equity payout is payment commensurate with previously established interim pro-rated performance hurdles, and the $2,000,000 payout is based on actual performance by the company and the attainment of the performance hurdles was not caused by a CIC (i.e. stock price jump after the announcement of a CIC). In this case, only $380,000 of the $2,500,000 payment would be subject to the 20% 280G excise tax (i.e. excise tax due of $76,000).

Part 4: The "Gross-Up"

The Gross-Up Payment

– Many executive Employment Agreements provide for what is known as a “280G Gross-up Payment”

– In general, this provision provides that if an executive incurs excise taxes triggered by IRC Section 280G, a gross-up payment would be made such that the executive is made whole for any 280G excise tax due on the pre gross-up parachute payments.

– Without this provision, if an executive were to exceed his/her threshold amount, the effective tax is likely to exceed 60% (in NJ the marginal income tax rate would be closer to 70%).

– On the other hand, because of the extremely high tax rate, the gross-up payment could very well be the largest parachute payment made to the executive upon a CIC.

• Where a DI’s marginal income tax rate is 65 % (including 20% excise tax), the gross-up cost is $2.86 for every dollar of excise tax.

– Shareholder activist groups such as RiskMetrics Group have become aggressive in forcing companies to reconsider gross-ups.

• The shareholder advisory group RiskMetrics Group (formerly known as Institutional Shareholder Services or “ISS”) indicated in their 2009 Policy Updates (issued in November

2008) that they would consider issuing a withhold/against vote recommendation for compensation committee members of an S&P 500 company that enters into a new or substantially amended agreement which provides for a 280G gross-up.

• This aggressive approach underscores the need for companies to constantly plan and monitor this exposure.