# Private Corporations and the New Golden Parachute Regulations

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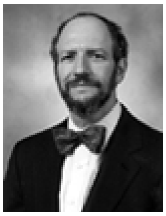

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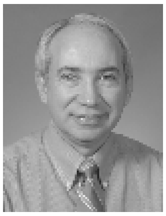

***Revisit executive compensation plans to check for compliance.***

The Internal Revenue Service (IRS) on August 4, 2003, published interpretive regulations relating to golden parachute payments.[1] These are the first final regulations that have been issued on the topic since the golden parachute statute was enacted in 1984.

The statute applies to certain excessive payments in the nature of compensation that are paid by a corporation that is subject to the statute to an individual on a change in the ownership or effective control of the corporation or its assets. A parachute payment can result in both the loss of the corporate tax deduction for the payment and the imposition of a nondeductible 20% excise on the recipient. Although designed chiefly for large, public companies, the golden parachute sanctions can also apply to private corporations. This article focuses on how private corporations can avoid these harsh sanctions.

The golden parachute sanctions do not apply unless the parachute payment that is contingent on a corporation's change in control is "excessive." Therefore, as a first strategy for avoiding the sanctions, planners should take advantage of the rules that exempt or exclude certain amounts from the definition of a parachute payment. In particular, payments constituting reasonable compensation and payments under tax-qualified retirement plans are not counted as parachute payments.

A second strategy is available only to private corporations whose stock is not publicly traded. Parachute payments by private corporations can be completely exempted from the sanctions by

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obtaining appropriate shareholder approval of the payments. However, complying with the shareholder approval requirements is not straightforward. The new regulations interpret the approval requirements stringently, and compliance may require departures from traditional business practice.

Nevertheless, understanding the new regulations is the best means available to compensation planners to reduce the likelihood that private corporations and their executives will be surprised by golden parachute sanctions. Because the regulations apply to any payments attributable to a change of the company's ownership or control that occurs after December 31, 2003 (even if made pursuant to an agreement dated earlier), the final regulations should prompt compensation specialists to revisit current compensation plans, as well as carefully to review new arrangements.

## Typical Golden Parachute Payments

A golden parachute is a payment in the form of cash, property or an acceleration of vesting that occurs in connection with a change in the ownership or control of a corporation's stock or assets.[2] In the most straightforward case, an executive's employment agreement may provide for substantial cash payments if he or she is terminated or demoted in connection with a change in control. Executive compensation may also include stock options or deferred compensation rights whereby vesting will be accelerated if a change in control should occur, and these too can create parachute payments.

A golden parachute may serve shareholder interests by giving an executive an incentive to facilitate, or at least not to obstruct, a change in control transaction that may be valuable to shareholders but that could lead to the loss of the executive's job. The existence of a golden parachute may also be needed to attract the best executives. The parachute obviously makes a executive's compensation package more attractive by incorporating a sort of insurance against dismissal or other deleterious consequences that might result from a takeover.

## Synopsis of the Statutes

Although golden parachutes may serve shareholder interests, in the early 1980s, Congress expressed concern that during corporate takeover battles, some executives received exceptionally large parachute payments. Congress was concerned that such payments inappropriately would either bias management to favor a takeover or discourage the acquirer from completing a takeover by adding the expense of the parachute payments to its cost.[3]

To discourage such excessive golden parachute payments, in 1984, Congress added to the Internal Revenue Code (hereafter "Code") Section 280G, which makes "excess parachute payments" nondeductible by the paying corporation. Also added was Code Section 4999, which imposes a nondeductible 20% excise tax on any person who receives an excess parachute payment.

➤ ***Section 280G.*** Code Section 280G makes nondeductible by the paying corporation "excess parachute payments" made to any "disqualified individual." The section defines a parachute payment as any payment that meets the following conditions:

***A golden parachute is a payment in the form of cash, property or an acceleration of vesting that occurs in connection with a change in the ownership.***

1. The payment is in the nature of compensation;

2. the payment is to, or for the benefit of, a disqualified individual (a significant shareholder, officer or highly compensated employee);

3. the payment is contingent on a change in the ownership or effective control of a corporation or of a substantial portion of its assets; and

4. the payment has an aggregate present value of at least three times the individual's "base amount."

Excess parachute payments are defined as the excess of the parachute payments over the recipient's base amount. An individual's base amount is his or her average annual taxable compensation from a corporation during the most recent five tax years ending before the date of the change in control. If the individual was not employed by the corporation for the full five preceding years, the period is for his or her full employment ending with the preceding tax year. For example, assume that as of December 31, 2003, an executive has been employed for two years and four months and had income of $30,000 for the initial four-month period in 2001, $120,000 for the full year 2002 and $150,000 for the full year 2003. If a change in control occurs in 2004, the base amount would be ([3 x $30,000] + $120,000 + $150,000) / 3, or $120,000.[4]

The golden parachute rules do not apply if the total present value of the payments to an individual that are contingent on a change in control is less than three times the individual's base amount.

➤ ***Section 4999.*** Separately, Code Section 4999 imposes a 20% excise on any person who receives an excess parachute payment. The excise is in addition to the regular income tax and is itself nondeductible. Note that the individual may be subject to the excise even if the employer is unaffected by Code Section 280G (e.g., if the employer is a foreign corporation exempt from U.S. taxation). Conversely, the payment may be nondeductible to the paying corporation even if the recipient is not subject to the excise tax.

## Individuals Covered

The golden parachute provisions cover payments to individual recipients, called disqualified individuals, who perform personal services for a corporation and are any of the following:

1. A shareholder: a person who owns stock that constitutes at least 1% of the total fair market value of all outstanding shares.[5] For the purposes of calculating stock ownership, outstanding vested options are treated as if exercised; stock owned by family members and related entities may be treated as if owned by the individual.

2. An officer: an administrative executive who is in regular and continued service. Any person who has the title of an officer is presumed to be one, unless facts and circumstances demonstrate that the individual in fact does not have the authority of an officer. Conversely, a person without an officer's title may be one, if he or she in fact has the authority of an officer. Generally, no fewer than three nor more than 50 persons (or if fewer, 10% of the employees) will be treated as officers within any corporation (or affiliate).

3. A highly compensated individual: a person who is one of the highest paid 1% of employees of the corporate group, provided such person earns at least $90,000 annually.[6] Note that a highly compensated individual cannot escape this status simply by redirecting compensation to a 401(k) or cafeteria plan.

***The golden parachute rules do not apply if the total present value of the payments to an individual that are contingent on a change in control is less than three times the individual's base amount.***

For the purposes of the 1% tests embedded in the definitions of a shareholder and a highly compensated individual, a corporation is deemed to include all of its affiliated companies. Hence, a person may be a 1% shareholder of a subsidiary, or among the subsidiary's highest paid 1%, but still fall outside the golden parachute provisions because he or she is not a shareholder or highly compensated individual with respect to the entire corporate group.

As a practical matter, it is rare that a parachute payment subject to the statutory sanctions would be made to an individual who turns out not to be a disqualified individual within the regulations; in the private company realm, this would be exceedingly unusual.

## Exempt Corporations

The regulations exempt S corporations (and corporations that could so qualify), tax-exempt organizations and private corporations that obtain shareholder approval of the parachute payment.

➤ ***S-eligible corporations.*** An unqualified exemption exists for payments by a corporation that meets the definition under Code Section 1361(b) of a "small business corporation," as modified. A small business corporation is a corporation eligible to make an S election—namely, a domestic corporation having only one class of stock and having not more than 75 shareholders, all of whom are individuals or eligible trusts and none of whom are nonresident aliens. The new regulations extend the definition to include otherwise qualifying corporations that have one or more nonresident alien shareholders but do not extend it to include foreign corporations. Under the statute and the final regulations, payments by such a corporation—provided it retains its small business corporation status as of the time of the change in control—will be exempt from the parachute provisions. It is not necessary that the corporation actually file an S election at any time.

It appears, however, that this exemption will not be available if an ineligible shareholder (e.g., another corporation) acquires stock of a small business corporation, even if it does so as part of a process that leads directly to a later change in control. For example, suppose change in control payments were agreed to by an employer that historically has been an S corporation. On January 1, 2004, another corporation acquires 18% of the stock of the employer, thus automatically terminating the S election. On October 1, 2004, the same corporation acquires an additional 33% of the employer's stock, thus triggering a change in control under the parachute rules, and parachute payments are then made to the executive. Apparently, because the employer ceased to be eligible to be an S corporation on January 1, the payments are not exempt from the parachute rules because the employer was not an eligible small business corporation at the time the change in control occurred, that is, when the final 33% block was acquired.

➤ ***Tax-exempt organizations.*** Payments made by Code Section 501(c)(3) organizations and certain other tax-exempt entities in connection with a change in the organizations' ownership or control are exempt from the parachute provisions under the final regulations. However, the exemption is available only if an organization is tax exempt both immediately before and immediately after the change in control. Hence, even if payments are contractually agreed to by a qualified Code Section 501(c)(3) organization, the exemption is not available if the entity later loses its exempt status as a result of the change in control.

➤ ***Private companies.*** The most important exemption from the parachute rules concerns private corporations—those whose stock is not readily tradable on an established securities market, or otherwise, immediately before the change in control.[7] Parachute payments by such corporations are exempt if, but only if, they are appropriately approved by the shareholders. The rules governing the method of this shareholder approval constitute crucial aspects of the new regulations and are further discussed below.

## The 300% Safe Harbor

The statutory "safe harbor" completely exempts parachute payments if the total present value of the payments contingent on a change in control is less than three times the individual's base amount.

For example, during the five years ending December 31, 2005, Executive A receives total cash salary of $600,000 and property with a fair market value of $400,000. Her average annual total taxable compensation—the base amount—for the relevant period is $1,000,000 / 5, or $200,000. Assume that a change in control occurs during 2006. If Executive A receives payments contingent on the change in control with a present value of less than $600,000, the golden parachute sanctions will not apply.

If the payments contingent on the change in control are not within the safe harbor, then the payments in excess of the base amount (not three times the base amount) are subject to the sanctions. Thus, in the preceding example, if Executive A's payments contingent on the change in control had a value of $700,000, the nondeductibility and excise sanctions would apply to $500,000 of such payments.

A corporation can avoid the golden parachute sanctions by keeping the total of the parachute payments below the 300% limit. Of course, this can be accomplished by reducing the total compensation that is contingent on a change in control, but it also can be accomplished through increasing the base amount. For example, if in 2005, Executive A exercises an option that is $100,000 in the money, the total compensation paid to her in the five years ending 2005 would increase from $1,000,000 to $1,100,000. This would increase Executive A's base amount from

$200,000 to $220,000. As a result, she may now receive parachute payments of any amount less than $660,000 without the golden parachute sanctions applying. The base amount could be further increased if a bonus due to her in March 2006 were instead paid to her in December 2005.

➤ ***Predicting the safe harbor.*** At the time of hiring, it can be difficult to ensure that under any particular compensation plan, the total of all parachute payments will stay under the 300% limit, particularly because the future value of stock options and other equity compensation (as well as bonuses) will be uncertain. To reduce their exposure to the golden parachute sanctions, the parties might agree that the parachute payments will be reduced to remain within the safe harbor. For example, an employment agreement could provide that if on a change in control the total of parachute payments turns out to be more than 299% of the base amount, but less than 320%, the executive will receive only payments equal to 299% of the base amount.

This would leave the employee better off after taxes than he or she would have been with the unreduced package and a large excise tax bill. However, even at the time of a change in control, the value of parachute payments (and of the base amount) may be known only approximately, both because of uncertainties of valuation and because of legal uncertainties as to whether (or to what extent) various regulatory exceptions apply.[8] It may not be clear (and the parties may not agree) whether the actual parachute is in the 299% to 320% range, nor whether the reduced payment would prove on audit to be inside the safe harbor. Because of these uncertainties, and because the parties' interests are not fully aligned, such an arrangement should be carefully thought through.

## Calculating the Payment

Plainly, the application and the severity of the golden parachute sanctions is very sensitive to calculating the precise amount of the parachute payments. The total amount of parachute payments may be reduced by any of the several exemptions that are provided by the statute and the new regulations. At the time of hiring, structuring the compensation package carefully can maximize the available exemptions.

In general, parachute payments are considered made and are subject to the excise of Section 4999 in the tax year in which they are included in the gross income of the recipient.[9] For the purposes of the 300% test, the total present value of all payments is determined as of the date of the change in control.

Parachute payments include any property (as well as cash), the payment of which is contingent on a change in control.[10] The regulations provide that noncash property is to be valued at its current fair market value. Similarly, rights to receive future payments in cash or property are included at their present value; the discount rate for purposes of calculating the present value is 120% of the applicable federal rate.[11] The valuation of stock options is a key subject of the new regulations, as discussed below.[12]

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The key exclusions from parachute payment status under the statutes and the regulations are payments not contingent on a change in control, payments not in the nature of compensation, payments reflecting reasonable compensation for services rendered and payments under a tax-qualified retirement plan. The rules governing each of these exclusion are reviewed in more detail below.

A corporation will sometimes agree to "gross up" parachute compensation by paying a sum sufficient to assure an executive of a certain payment, net of the excise and all other taxes. For example, a corporation might agree to provide Executive A with a net payment of $700,000. Assuming that Executive A's base amount is $200,000, the total amount the corporation will have to pay to Executive A is approximately $1,650,000. The excise tax will be 20% of $1,650,000 less $200,000, or $290,000. The entire $1,650,000 will be subject to federal personal income taxes and FICA and probably to state personal income taxes as well; at a combined effective rate of, say, 40%,[13] a tax bill of $660,000 results. The net payment to Executive A is then $1,650,000 – $290,000 – $660,000 = $700,000. In this example, the net expense to the corporation of the gross-up arrangement is roughly $2.36 for each dollar of net benefit to the executive.

### Payments Not Contingent on a Change in Control

Payments are subject to the sanctions only to the extent that they are contingent on a change in the ownership or effective control of a corporation.[14] Such a change in ownership occurs when within a 12-month period, stock changes hands such that a person, or a group of persons acting together, comes to own more than 50% of the value of the corporation or more than 50% of the voting power of the corporation.[15] The golden parachute rules can also be triggered by asset sales; generally, a transaction that disposes of more than one third of the gross value of a corporation's assets will effect a change in ownership under the parachute rules.

For th purposes of the golden parachute rules, an affiliated group is treated as a single corporation. Thus, if a public corporation sells all of the stock (or assets) of its wholly owned subsidiary, but the value of the subsidiary was, for example, only 20% of the group's total value, the transaction would not trigger application of the sanctions.

If a payment is contingent on an event closely associated with a change in control, for example, the retirement of the chief executive, then the payment may be considered to be contingent on a change in control. Note that a corporation's agreement with an executive may provide a definition of a change in control that may not coincide with the definition provided by the regulations.

If a payment is not contingent on a change in control, but would have been paid in any case, it is not a parachute payment. For example, if restricted stock or options would vest at a particular time regardless of the change, they are not included as a parachute payment.[16] On the other hand, if stock vests under a particular schedule, but a change in control accelerates the date of vesting, the accelerated vesting is regarded as contingent on the change in control.

➤ ***Agreements made after a change in control.*** Payments pursuant to an agreement that is entered into after a change in control are not included in the parachute payment. As a result, new agreements that are negotiated after a change in control has been completed are not affected by the golden parachute rules. However, the rules nevertheless could apply if payments under the new agreement are merely substitutes for parachute payments that were negotiated prior to the change. For example, assume that a corporation undergoes a change in control and that as a result, Executive A is entitled to a parachute payment of $700,000. After the change in control, Executive A agrees to stay on at an increased salary and to waive the parachute payment. The increase in salary, up to $700,000, may be considered a parachute payment.[17]

Similarly, in a recent case,[18] the tax court held that even though employment agreements were entered into after a change in control, certain lump-sum payments made thereunder were parachute payments. In that case, a publicly traded corporation and 16 of its executives entered into employment agreements, which provided a parachute payment to any executive who chose to leave in the 13th month after a change in control or if he or she was fired within 36 months of a change in control. After the corporation's acquisition the next year, the acquiring company sought new employment agreements with the executives.

Some of the executives used the promised parachute payments as leverage to secure lump-sum payments under the new agreements; the new lump-sum payments were larger than the original parachute payments but contingent on the executives' remaining with the company for a certain period of time. On these facts, the court held that the entire amount of the lump-sum payments, less any reasonable compensation, constituted parachute payments. The court concluded that these payments would not have been made but for the change in control and so were contingent on the change within the meaning of the regulations, even though they were agreed to after the change.

➤ ***Agreements made within one year prior to a change in control.*** Importantly, if a payment under a new agreement is made within one year prior to a change in control, the payment is presumed to be contingent on the change in control and therefore to be a parachute payment. The taxpayer may rebut this presumption on a showing by clear and convincing evidence that the payment was independent of the change in control, that is, that it would have been paid in any case. For example, a history of regular increasing option grants over many years may rebut the presumption that a recent grant (even if larger than last year's) was made in connection with an expected change in control.[19]

### Payments Not in the Nature of Compensation

Payments that are not in the nature of compensation are not subject to the parachute rules. For example, payments in the nature of interest for the use of capital are not compensation. Principals of a private corporation may hold substantial stock of their employer; if such stock were repurchased in connection with a change in control, gains attributable to increases in the stock price would be excluded from the parachute payments.

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Commonly, private corporation executive stockholders are required to accept significant restrictions on their stock as a condition for obtaining additional financing, either from lenders or from venture capitalists. As a result, their already vested stock may effectively become unvested. In such a case, the corporation might provide that these restrictions will be removed in the event of a change in control; that is, that "unvested" stock will "revest." Although the revesting is clearly contingent on a change in control, any increased value is nevertheless excluded from the calculation of the parachute payment. Because the executives originally held the stock outright, any subsequent gain is not considered taxable compensation income and hence is not included as a parachute payment.[20]

### Reasonable Compensation

Any part of a change-in-control payment that represents reasonable compensation for personal services rendered (or to be rendered) by an individual is not treated as a parachute payment. However, the taxpayer must by clear and convincing evidence establish that a payment that is contingent on a the change in control is reasonable compensation.

If so established, the reasonable compensation is deducted before the three-times-base-amount test is applied. Assume that Executive A has a base amount of $200,000 and that she received payments contingent on a change in control of $700,000, but $100,001 of this represented reasonable compensation for services rendered. In this case, no portion of the payment is subject to the golden parachute rules.

Payments made under a "nondiscriminatory employee plan" are deemed to be reasonable compensation. Such plans include (among others) group term life insurance plans, cafeteria plans, educational assistance programs and dependent care programs.

➤ ***Compensation under new agreements.*** Payments made under a new employment contract with an acquiring corporation, even if it is executed before the change in control is consummated and replaces a prior employment agreement, may be excluded from parachute payments if the new payments represent reasonable compensation for services. To show reasonability, the taxpayer may offer evidence regarding the nature of the services, his or her historic compensation for such services and comparable compensation (not contingent on a change in control) offered to other individuals. Also useful would be opinions of compensation consultants that were prepared contemporaneously with the negotiation of the compensation agreement.

If the salary and benefits with the new employer do not represent a substantial increase over the executive's compensation before the change in control, the new salary and benefits should be considered as reasonable compensation for services. On the other hand, the new regulations make clear that if an individual receives substantially higher compensation after a change in control than he or she was paid for essentially the same services before the change, then the increase in every case may be recharacterized as a parachute payment.[21]

Payments for a covenant not to compete may also be reasonable compensation. Under the regulations, a taxpayer must demonstrate that the covenant in fact substantially constrains the individual's ability to perform services and that it is reasonably likely to be enforced by the employer.

Despite the requirement of clear and convincing evidence, advantage may be gained from the use of covenants not to compete and post-termination consulting arrangements. It is often demonstrable that an executive's agreement to refuse employment with competitors and to be available for ongoing consulting has significant value to the new corporation.

### Payments under Qualified Retirement Plans

Payments under tax-qualified retirement plans are exempt from the parachute rules. In some cases, it will be possible to enhance qualified defined benefit plan accruals for top executives in connection with a change in control (within the qualified plan nondiscrimination rules) and thus circumvent the golden parachute provisions.

## Valuation of Stock Options

Stock options—rights to purchase equity shares at a specified "strike" price—provide an additional incentive for employees to enhance the financial success of the company and can generally be provided without immediate cost to the company.[22] Stock options may be granted in connection with a change in control, in which case the value of the options must be included as parachute payments.

More commonly, stock options are granted subject to a vesting schedule, which may include a proviso that they will vest on a change in control.[23] In such case, an amount representing the value of the accelerated vesting must be included as part of the total parachute payment. In both cases, the valuation of the stock option will affect eligibility for the safe harbor or, if the safe harbor is exceeded, the amount of parachute payment subject to the sanctions. The determination of the value of the options hence can be critical.

➤ ***Stock option valuation methods.*** To determine the amount of a parachute payment created by the granting or accelerated vesting of stock options, a mathematical model must be used, such as the calculation developed by Fischer Black, Myron Scholes and others.[24] Under Revenue Procedure 2003-68, which was issued simultaneously with the new regulations, a taxpayer may now use any of several approved valuation methods, including a new abbreviated safe harbor method based on the classic Black-Scholes analysis.[25] Any method is allowed provided that it is consistent with generally accepted accounting principles and takes into account all relevant facts and circumstances. At a minimum, a valuation must take into account at least four factors: (a) the exercise price "strike price" of the option, (b) the value of the underlying stock at the time of vesting ("spot price"), (c) the probability that the stock price will change over time ("volatility") and (d) the length of time over which the option may be exercised ("maximum remaining term"). It is insufficient to consider only the difference between the strike price of the option and the spot price at the time of the change in control.

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➤ ***Stock options that vest on change in control.*** When a parachute payment is created by the accelerated vesting of stock options (or other deferred compensation), the amount of the parachute payment is determined as the sum of two elements: The first element represents the time-related value of the recipient's receiving the payment earlier, and the second element represents an adjustment for the lapse of the individual's obligation to perform services to preserve his or her rights under the option. The total value of the acceleration is calculated as the sum of

1. the difference between the value of the accelerated payment and the present value of the payment(s) absent acceleration (the present value being determined by discounting back to the change in control date, at 120% of the applicable federal rate) and

2. the value of the accelerated payment multiplied by 1% for each month between the change-in-control date and the date the option otherwise would have vested.

For example, assume that a change in control occurs today. An employee holds unvested options that would otherwise vest in one year, but as a result of the change in control, all of the options vest now. Assume that the value of the options today (as determined under an appropriate multifactor valuation formula) is $100,000. Assume also that 120% of the applicable federal rate is 5%. The present value of the options one year hence would be calculated as $95,238. The difference of $4,762 is one element of the value of the parachute payment. The second element is $12,000 ($1,000 per month for the 12-month period from now until the original vesting date). Thus, the total value of the vesting acceleration is $16,762.

Under the new revenue procedure, the initial valuation of an option may be recalculated by the taxpayer and the test for determining excess parachute payments reapplied for a period of 18 months after the change in ownership or control.[26] Change in value during this 18-month period may be triggered by a change in the volatility of the stock. This provision of the regulations is especially helpful to private corporations. In takeover scenarios, private corporations often have volatile stock; if a company stabilized after acquisition so that volatility decreased, the taxpayer may be able retroactively to reduce the amount of the parachute payment. Note that because of the possibility of such a future reduction, at the time of a change in control, both the company and the executive may be uncertain as to whether any particular payment that includes stock options exceeds the 300% safe harbor.

Note that if an option vests because of the change in control, a subsequent payment on disposition of the option (i.e., the exercise or "cashing in" of the option) is not treated as an additional payment. Similarly, if an already vested stock option is cashed out or exercised in connection with a change in control, the cash-out payment or value of stock received is not treated as a parachute payment. For example, assume that an executive acquired stock options as compensation for services under an agreement made at least one year ago and that the options are now fully vested. Anticipating a change in control, he decides to exercise the options by paying $100,000 for stock worth $600,000, which he then sells. The $500,000 gain is not treated as a parachute payment. As noted above, such income can helpfully increase the executive's base amount if it is recognized in a year before the change in control occurs.

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## Shareholder Approval

Even if, after adjustment for reasonable compensation and other exemptions, and using appropriate valuation methods, a parachute payment will equal or exceed 300% of the individual's base amount, a private corporation may still avoid the statutory sanctions by obtaining shareholder approval of the payment.

For a payment by a private corporation to be exempt under the shareholder approval exception, Code Section 280G requires (a) that the payment be approved by a vote of persons who owned, "immediately before" the change in control, more than 75% of the voting power of all outstanding stock of the corporation, and (b) that there was adequate disclosure to shareholders of all material facts concerning the payments. This leaves open numerous interpretative questions, which the new regulations address in a manner generally unfavorable to taxpayers.

➤ ***Form of approval.*** Must the payments be contingent on shareholder approval? Although the statute states that the payments must be approved by an appropriate vote, it does not explicitly state that the payments must be contingent on the vote. However, the final regulations insist that the exemption is available only if the shareholder vote is absolutely determinative of the right of the executive to receive or to retain the payments. Commonly, an executive's compensation package, including payments contingent on a change in control, is negotiated at the beginning of employment, without any shareholder approval. Later, when a change in control is contemplated, if it appears that the contingent compensation will exceed the safe harbor, then the executive and the employer face a difficult choice under the new regulations.

To benefit from the exemption for private corporations under the regulations, the executive will have to waive any right to the excess payments; the parties may then renegotiate the same (or different) parachute payments, but such payments must be contingent on shareholder approval if they are to avoid sanctions. Alternatively, the executive may accept the original parachute payments and pay the excise, in which case the excess payments will not be deductible by the employer.

The IRS itself acknowledges that the requirement for shareholder approval on the eve of a transaction is at variance with current business practice, but it justifies the requirement as consistent with its view that Congress designed the requirement to discourage parachute payments.[27]

What if the shareholders are asked to approve the payments, with the stipulation that the payments are strictly contingent on a majority (not necessarily 75%) approval being obtained? What if more than 75% in fact approve, but only majority approval was solicited? Under the final regulations, in both such cases, the exemption from tax will not be available. The exemption is available only if the payments will not in fact be made unless the 75% approval is obtained. This provision heightens an executive's risk in agreeing to relinquish his or her rights to payment unless appropriate approval is obtained.

Will approval by individuals holding more than 75% of the voting power suffice even if other minority shareholders are uninvolved? Suppose two individuals own 80% of the stock of a corporation. Will their approval of a payment be adequate even if the approval of holders of the other 20% is not solicited? On the eve of change in control transactions, a simple approach such as this frequently is desired, because it may be expensive and awkward to solicit numerous small shareholders whose approval appears functionally irrelevant. Under the final regulations, such an approach will not suffice to avoid the sanctions. The regulations require that "adequate disclosure of all material facts" must be made to "every shareholder of the corporation entitled to vote." Even if 100% of the shareholders are solicited, if the disclosure to any one of the shareholders is not "adequate," the vote apparently is invalid.

***The regulations require that "adequate disclosure of all material facts" must be made to "every shareholder of the corporation entitled to vote."***

May the shareholders approve parachute payments to several individuals in a single vote? Generally, the shareholders can vote on all payments to any one individual or on all payments to more than one individual. In any case, however, the vote to approve parachute payments must be separate from (and not contingent on) the vote to approve the change in ownership or control itself. Note that no particular shareholder may vote shares to approve his or her own parachute payment.

Consider a case in which five executives each hold one fifth of the voting shares. For parachute payments to each of them, all of the other four shareholders must assent to meet the shareholder approval requirements.[28] What if all the shareholders vote, in a single vote, to approve all of the parachute payments? Certainly, structuring the vote this way would increase the likelihood of approval. The regulations suggest, however, that in this case, the vote is invalid because no shareholder would be entitled to vote.[29]

➤ ***Timing of approval.*** Given that the identity of the shareholder group can change over time, when does one determine the identity of the shareholder group of which 75% must consent? When must the vote occur? Final regulations provide that a 75% vote will be valid if 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 in control. Thus, a vote by more than 75% of the shareholders of record on August 1, 2004, will be valid with respect to a change in control occurring in January 2005, even if there has been a significant change in the identity of shareholders before the change in control.

Suppose, however, that the vote takes place more than six months before the change in control, but there has been no change in the identity of the shareholders. Indeed, suppose that the shareholder vote occurs when an executive is hired, and the parachute provisions are included in his compensation package, but the change in control does not occur until several years after such date. If there has been no change in the identity of the shareholder group, arguably, the statutory requirement will have been met because the parachute payments were approved by a 75% vote of the persons who owned voting stock of the corporation immediately before the change in control. That is, the statute does not explicitly provide that the vote itself must occur immediately before the change in control but simply requires that the persons who participated in the vote must be substantially identical to the group that owns the stock immediately before the change in control.

The final regulations do not clearly address this question. Nowhere do they state that the vote itself must take place at any particular time, and they explicitly acknowledge that the identity of the relevant shareholders may be determined on any day within the six-month window, regardless of whether there is a vote on that day. It would have been easy for the final regulations to include an example of a vote occurring more than six months prior to the change in control where the shareholder group remained unchanged, but no such example exists.

On the other hand, the final regulations provide that if "adequate disclosure" is not provided to any shareholder before the vote, the vote is not valid. Thus, a vote occurring outside the six-month period apparently will be invalid if there has been any change whatsoever in the identity of the shareholders between the time of the vote and the beginning of the six-month period (although perhaps changes in relative shareholdings are not relevant).

***The new final regulations seek to discourage excessive golden parachute payments.***

➤ ***Planning for shareholder approval.*** Surely, private corporations should consider obtaining shareholder approval of parachute payments when a change in control is anticipated. However, even if not contemplating any change in control, private corporations with stable pools of shareholders should consider obtaining shareholder approval of newly negotiated parachute payments. If the members of the shareholder group at the time of approval in fact remain unchanged until six months prior to any change in control transaction, obtaining these early approvals will have preserved a tenable argument that the required shareholder approval has been obtained, even if it later turns out that actual shareholder approval was not obtained within the six-month period.

## Conclusion

The new final regulations seek to discourage excessive golden parachute payments. Private corporations must plan carefully if they and their executives are to avoid the harsh sanctions imposed by the golden parachute statutes. Compensation specialists should review their executive compensation arrangements to ensure that they remain optimal in light of the new final regulations. The following strategies are suggested.

### In Advance

1. Mind the safe harbor. Attempt to keep the total of payments contingent on a change in control within the three-times-base-amount limit. Consider entering into an agreement with an executive to reduce parachute payments to the extent required to remain within the safe harbor.

2. Be judicious in grossing up. Recognize that grossing up compensation that is subject to the excise to assure an executive a specific after-tax package will create an expensive tax on the tax.

3. Use stock options wisely. Understand that the accelerated vesting of stock options or other rights on a change in control can trigger golden parachute sanctions.

4. Consider securing early shareholder approval. If the shareholder group is unlikely to change, consider obtaining shareholder approval for negotiated parachute payments, even if no change in control is expected. Although the early approval may turn out not to be valid at the time of a change in control, there is no disadvantage in obtaining the approval early.

### At the Time of a Change in Control

1. Consider executive waiver. If a preexisting employment agreement would provide a severance payment in excess of the three-times-base-amount limit, an executive might waive any right to the excess payments once the change of control is in view. The amount waived (or a different amount) might be approved by shareholders at that time and then reinstated.

2. Increase the base amount. In some cases in which a change in control is anticipated in the following year, it may be possible to increase the base amount of the executive, for example, by exercising previously vested options or by accelerating the payment of bonuses.

3. Obtain shareholder approval. Following the prescribed procedures, obtain shareholder approval of parachute payments when a change in control is anticipated.

4. Review valuations later. If there was a parachute tax problem, before the expiration of 18 months after the change in control, review the valuation of any stock options included in the parachute payment to determine if the valuation was too high in view of later changes in volatility or other changes.

## Notes

1. T.D. 9083 (August 1, 2003) IRS Final Rules on I.R.C. § 280G Golden Parachute Payments, adding new § 1.280G-1 to Treasury Regulations (hereafter "Regs.").
2. Parachute payments are often formalized in an executive's employment contract and may be conditioned on the termination of the executive's employment. However, neither a written agreement nor termination of employment is required to fall within the rules. See, for example, *Cline v. Commissioner of Internal Revenue*, 34 F.3d 480 (7CA, 1994).
3. General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, Joint Committee on Taxation (1984), at pp. 199-207.
4. Regs., Q/A-35, Example 1. Note that the initial part-year period is annualized before calculating the average; as a result, the base amount is not identical to the arithmetic mean for the 28-month period, which would be $300,000 x 12 / 28 = $128,571.43.
5. A provision of the proposed regulations making a person a disqualified individual if he or she owned stock of the corporation with a fair market value of more than $1 million, even if less than 1% of the outstanding stock has been removed from the final regulations.
6. The minimum salary is adjusted annually. The $90,000 figure is for 2004. See Notice 2003-73, 2003-45 IRB 1017 (November 17, 2003).
7. Regs., Q/A-6(a)(2). "Established securities markets" include Securities and Exchange Commission–registered national securities exchanges as well as certain "over-the-counter" markets that have systems for disseminating quotations among dealers. See Treas. Regs., § 1.897-1(m). Even if not traded on an established securities market, stock is treated as readily tradable if it is regularly quoted by brokers or dealers.
8. Such provisions often are accompanied by corporate make-whole payments if the parachute is not cut back and the excise applies. See immediately below under "Calculating the Payment."
9. Regs., Q/A-11(b). The recipient has the option to prepay the excise in the year of the change in control, or any later year, Regs., Q/A-11(c); this may be useful in cases of grossing up.
10. Regs., Q/A-12. Note that nontaxable income is not included as a parachute payment.
11. Code § 280G(d)(4).
12. Regs., Q/A-13, Q/A-24. In connection with the final regulations, the IRS also issued Rev-

enue Procedure 2003-68, 2003-34 IRB 398 (August 2, 2003), which provides guidance on the valuation of stock options for the purposes of Code §§ 280G and 4999.

13. We assume that Executive A is in the highest individual federal tax bracket of 35% and that her total marginal tax rate is 40%, including FICA, state, and local taxes.
14. Payments are also subject to the golden parachute sanctions if they violate securities laws, even if not contingent on a change in control. See Regs., Q/A-39.
15. Regs., Q/A-27. A change in effective control is arguably presumed to occur when any one person or group acquires 20% of the total voting power, or when a majority of the board of directors is replaced. Regs., Q/A-28.
16. IRS Private Letter Ruling 9608020 (February 23, 1996).
17. Regs., Q/A-23(b), Example 3. See also Regs., Q/A-26.
18. *Square D Company and Subsidiaries v. Commissioner*, 121 Tax Court (No. 11) (September 26, 2003).
19. See Regs., Q/A-26, Example 2.
20. IRS Private Letter Rulings 200212005, 200212007 and 200212008 (March 22, 2002).
21. Regs., Q/A-26, Q/A 42. See also *Cline v. CIR*, op. cit. n. 2.
22. Note, however, that current proposals before the Financial Accounting Standards Board would require employers to expense stock options at fair value, or intrinsic value, when granted. See Islieb, B., Marks, B., & Wolfe, M. N. (2003). Employee stock options: Alternative valuation methods. *Compensation & Benefits Review*, *35*, 46-52.
23. Note that any acceleration of vesting of any deferred compensation that occurs within one year before a change in control will be presumed to be contingent on the change in control within the meaning of the statute.
24. The Black-Scholes formula takes into account time, interest rates and uncertainty in determining the value of stock options. See Black, F., & Scholes, M. (1973). The pricing of options and corporate liabilities. *Journal of Political Economy*, *81*, 637-654.
25. The safe-harbor method tends to produce higher valuations than the classic Black-Scholes formula.
26. Rev. Proc. 2003-68, paragraph 3.
27. See preamble to the Regs., discussion of Q/A 7.
28. The shares of disqualified individuals are not counted for purposes of the vote; hence, in the example, more than 75% of the shares of the remaining four shareholders (i.e., more than three) must approve.
29. Regs., Q/A-7, Example 4.

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