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ARTICLES

Golden Parachutes — New Planning Opportunities

by Thomas W. Meagher, Terry Adamson and Donald G. Harrington[*]

Summary:

Earlier this year, the IRS released a comprehensive set of proposed regulations for golden parachute payments, along with guidance regarding the determination of value for compensatory stock options, which are often an important factor in concluding whether or not a termination of employment payment is in fact, subject to excise tax under the golden parachute rules. This article summarizes the background of the golden parachute rules and provides useful tips for planning opportunities under these rules.

With every corporate merger or acquisition, there are a number of issues that can affect the transaction price and the financial value to be realized by shareholders. One significant issue that is often overlooked until late in the transaction process is the payment of compensation and other benefits to certain executives by reason of the merger or acquisition.

There are a myriad of different types of compensation arrangements that employers may enter into with their executives. In many of these arrangements, employers provide for enhanced compensation to executives upon the occurrence of a change in control. Traditionally, the intent of these enhanced compensation arrangements is to provide employers with some degree of comfort that their senior executives will be evaluating major corporate restructuring transactions from the perspective of maximizing shareholder value without being distracted by concerns over their individual employment or compensation situation. Despite an employer's attempt to provide for its executives upon a change in control, employers and executives have often been quite surprised when they learn how the change in control payments may be impacted once the parachute payment rules are applied.

GOLDEN PARACHUTE RULES—BACKGROUND

Prior to enactment of §280G of the Internal Revenue Code of 1986, as amended (Code), severance payments made to senior executives in connection with a corporate transaction were generally only subject to the dollar limitation on corporate income tax deductions under §162 of the Code. As a consequence of all of the corporate transactions in the early 1980's, coupled with the magnitude of the payments made to senior executives in connection with such transactions, Congress concluded that restrictions needed to be imposed on the payments to executives following a change in control. Consequently, with enactment of the Deficit Reduction Act in 1984, Code §§280G (which describes the rules for determining what payments may constitute parachute payments) and 4999 (which imposes the 20% nondeductible excise tax on excess parachute payments) were adopted.

In 1989, the Internal Revenue Service (IRS) issued proposed regulations (''1989 proposed regulations'') that established the rules for determining what payments were to be treated as contingent on a change in control and the circumstances under which such payments may be subject to an excise tax.[1]

GOLDEN PARACHUTE RULES — RECENT DEVELOPMENTS

Employers and their advisors relied on the 1989 proposed regulations in designing change in control programs that were intended to provide financial protection for their executives. Despite the guidance provided by the 1989 proposed regulations, employers were often required to wrestle with the meaning and intent of certain aspects of the regulations in designing change in control compensation packages and in determining whether the payments to executives following a change in control were subject to the excise tax under §4999. As change in control transactions and the compensation arrangements designed by employers became more and more sophisticated over the years, employers and their advisors faced increasing uncertainty as to how the 1989 proposed regulations should be applied. In response to these concerns, on February 20, 2002, the IRS issued long-awaited guidance (''2002 proposed regulations'') addressing many of the issues of concern to employers.[2] Among other things, the 2002 proposed regulations provide a window of opportunity for employers. Because the 2002 proposed regulations do not become effective until

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[1] PS-217-84, 54 Fed. Reg. 19390 (5/5/89), corrected at 54 Fed. Reg. 25879 (6/20/89).

[2] REG-209114-90, 67 Fed. Reg. 7630.

ISSN 0747-8607

January 1, 2004, employers are permitted to rely upon either the 1989 proposed regulations or the 2002 proposed regulations in their interpretation of the payments made to executives following a change in control occurring prior to January 1, 2004.

Along with the issuance of the 2002 proposed regulations, the IRS released Rev. Proc. 2002-13,[3] effective April 26, 2002, which provides guidance on calculating the value of compensatory stock options for purposes of calculating parachute payment amounts upon a change in control. Because the 1989 proposed regulations were ambiguous with respect to the proper method to value compensatory stock options, most practitioners merely assigned a value based on the difference between the underlying stock option's exercise price and the fair market value at the time of the change in control (i.e., the intrinsic value or ''spread''). Rev. Proc. 2002-13 provides a safe-harbor methodology that ultimately results in larger values being assigned to stock options, thus increasing their value to the extent they are somehow enhanced, or their vesting is accelerated, by reason of a change in control. Increased stock option values can result in increased parachute payment amounts under §280G, a situation that calls for some careful planning under Rev. Proc. 2002-13. Effective as of June 13, 2002, the IRS also issued Rev. Proc. 2002-45,[4] which modified the safe-harbor table established in Rev. Proc. 2002-13 to include a value for stock options that expire within three months of the *valuation date* and by clarifying that the ''spread'' methodology is not an acceptable method for valuing stock options.

IDENTIFYING PARACHUTE PAYMENTS

In attempting to maximize payments to executives upon a change in control while preserving deductions to employers, it is first helpful to review some of the basic elements of the parachute payment calculation. Once we have examined the components of the calculation, we can then apply these rules to specific situations and discuss the planning opportunities presented to employers and their advisors.

- **Parachute Payments.** Under the Code and Question & Answer 2 of the 2002 proposed regulations, a ''parachute payment'' is defined as any payment that is in the nature of compensation to, or for the benefit of, a disqualified individual, that is contingent on a change in ownership or control of the employer or in the ownership of a substantial portion of the assets of the employer. To the extent the aggregate parachute payment amount has a present value equal to or greater than three times the disqualified individual's base amount, the excise tax provisions of Code §4999 will become applicable. In evaluating parachute payments, however, it is important that the payments to executives and the reasons for such payment be carefully examined. For purposes of this article, we will briefly discuss some of the more significant aspects of the parachute payment definition below.

  - **Nature of Compensation.** The definition of ''compensation,'' which includes both cash and non-cash payments that relate to the performance of services, has remained largely unchanged under both the 1989 proposed regulations and the 2002 proposed regulations. Such payments include, but are not limited to, wages, salary, bonuses, severance pay, pension benefits and other deferred compensation and should include the value of a right to receive cash or a transfer of property.[5]

  - **Disqualified Individual.** As set forth in Question & Answer 15 of the 2002 proposed regulations, a ''disqualified individual'' is an individual who, during the ''disqualified individual determination period,'' is an employee, independent contractor or other person specified in the regulations (for example, a personal service corporation) who performs services for the employer or who is an officer, shareholder or highly compensated individual of the employer. The 2002 proposed regulations clarified this definition in three significant ways:

    - The ''determination period'' is now defined as the twelve months prior to and ending on the date of the change in control (i.e., a rolling 12-month period).[6] Previously, under the 1989 proposed regulations, the determination period ended on the date of the change in control and began on the first day of the preceding year;

[3] 2002-8 I.R.B. 549.

[4] 2002-27 I.R.B. 40.

[5] 2002 proposed regulations, Question & Answer (''Q/A'') 11. Unless otherwise noted, references to ''Q/A'' refers to specific Questions & Answers contained in the 2002 proposed regulations.

[6] Q/A-20.

ISSN 0747-8607

- A ''highly compensated individual'' is defined by reference to several factors including §414(q)(1)(B)(i) of the Code, under which there is a minimum salary of $90,000 for 2002 and 2003;[7] and

- A ''shareholder'' is now defined for purposes of §280G to include only individuals who own stock that has a fair market value in excess of one percent of the total fair market value of all classes of outstanding stock of the employer.[8] (The 1989 proposed regulations had a broader definition of ''individuals'' and included individuals who owned one percent of the outstanding stock of the employer, or owned stock of the employer valued at $1 million or more).

• **Contingent Payments.** Within Question & Answer 22 of the 2002 proposed regulations, the IRS clarified that a parachute payment is contingent on a change in control only if the payment would not have been made but for the change in control. Accordingly, if it is substantially certain that a payment would have been made regardless of the occurrence of a change in control, such payment will not be treated as contingent and, thus, would not be included as a parachute payment. Payments that are contingent on both a change in control and a second event — for example, a termination of employment, will be treated as contingent on a change in control and would be factored into the parachute payment calculations, even if the termination of employment occurs years after the change in control and may not be materially related to the change in control.

CALCULATING PARACHUTE PAYMENTS

• **Base Amount.** In order to determine the existence of a parachute payment and, ultimately, excess parachute payments, the disqualified individual's ''base amount'' must first be established. As defined in Question & Answers 34 and 35 of the 2002 proposed regulations, a disqualified individual's base amount is calculated by averaging the disqualified individual's compensation paid by the employer and included in the disqualified individual's taxable income during the five taxable years immediately preceding the year in which the change in control occurs. The disqualified individual's compensation includes, as discussed above, wages and salary, bonuses, severance pay, nonqualified pension benefits, deferred compensation payments, vesting of restricted stock, the exercise of stock options, and the continuation of health, welfare and fringe benefits following the change in control. If the disqualified individual has less than five full taxable years of compensation with the employer, his or her base amount is determined by calculating the average annual compensation received during the number of years the disqualified individual worked for the employer. In the event one of the years is a partial year, compensation received for services performed for the partial year is annualized and averaged with the other whole years.[9] An example of the base amount calculation appears as Example 1 below.

Example 1 - Calculating a Disqualified Individual's Base Amount

Year	Base[1]	Bonus[2]	Other[3]	Total
1997	N/A	N/A	N/A	N/A
1998	$118,100	$11,810	$5,903	$135,813
1999	$124,002	$12,400	$0	$136,402
2000	$130,203	$13,020	$0	$143,223
2001	$136,713	$13,671	$34,178	$184,562
''Base amount'' for 4 years[4]				$150,000

Assumptions for Example 1

Date of Hire – 10/1/1998

Date of Change in Control – 8/1/2002

[1] Includes total base salary annualized for any partial years and includes any excludible deferred compensation from Form W-2. Since the individual in this example was hired on 10/1/1998, their actual base pay earnings history of $29,525 has been annualized to a full year.

[2] Includes any annual bonuses and any sign-on bonuses.

[7] Q/A-19; Notice 2001-84, 2001-53 I.R.B. 642; IR-2002-111 (10/18/02).

[8] Q/A-17.

[9] Q/A-36.

ISSN 0747-8607

[3] Includes any other form of income such as relocation costs, Code §83(b) election income, vesting of restricted stock, exercise of stock options, etc.

[4] The disqualified individual in this example was hired in 1998, and therefore the base amount is the average of 4-years of compensation., i.e., 1998 through 2001 inclusive = $600,000 ÷ 4.

- **Determining the Value of Accelerated Payments.** If the vesting or actual payment of compensation is accelerated by reason of a change in control, all or a portion of the payment may be considered as being contingent upon a change in control and thus treated as a parachute payment under §280G. (In addition to cash payments, parachute payments may also include the value assigned to the acceleration of stock option vesting or the lapse of restrictions in connection with restricted stock, as well as other general equity-based awards that may become payable by reason of the change in control.) Within Question & Answer 24 of the 2002 proposed regulations, there is support for excluding a portion of the payment from the parachute payment amount because it is presumed under the proposed regulations that a portion of the payment is the employer's consideration for the employee's previous services. In Question & Answer 24(f), Example 1, the 2002 proposed regulations indicate that the portion of the payment that is determined to be contingent on the change in control (and includible as a parachute payment) is the lesser of the value of the accelerated payment or the amount by which the accelerated payment exceeds the present value of the payment absent the acceleration (determined as of the change in control date). The present value of the payment is determined by discounting for the future value of money and applying an interest rate of 120% of the applicable federal rate, and an amount to reflect the lapse of the obligation to continue to perform services. (This amount is equal to one percent of the accelerated payment for each full month between when the accelerated payment is vested and when it would have vested absent the acceleration.)

It should be noted that the 2002 proposed regulations clarify that if the present value of the payment is not reasonably ascertainable, or acceleration of the payment does not increase the present value of the payment in any meaningful amount, the value of the accelerated amount would equal the full amount of the payment that is accelerated by reason of the change in control and, thus, included as a parachute payment.[10]

- **One-Year Presumption.** All payments triggered by an agreement (or an amendment to an existing agreement) that was entered into within 12 calendar months before a change in control are presumed to be contingent on a change in control.[11] Such a presumption, however, is rebuttable by clear and convincing evidence. Such rebuttable evidence may include, for example, the content of the agreement or amendment, the likelihood of a change in control occurring when the agreement or amendment was executed, or a showing that the payment was made from a nondiscriminatory benefit plan.[12] From a parachute payment calculation perspective, however, the one-year presumption is crucial and will require that any modification (or a new agreement) entered into within 12 months of the change in control be carefully considered. Thus, employers and executives must carefully consider the financial implications (under §280G) whenever they are contemplating amending an existing agreement or entering into a new agreement within 12 months of a change in control.

- **Excess Parachute Payments.** To the extent the parachute payments have an aggregate present value of at least three times the disqualified individual's base amount, excess parachute payments will result and the parachute payment and excise tax rules of §§280G and 4999 will become applicable. Section 280G defines ''excess parachute payments'' as the parachute payment amounts that exceed one-times the disqualified individual's base amount.[13] Excess parachute payments are not deductible by the employer and will subject the disqualified individual to a nondeductible 20% excise tax on such amounts. (The 20% excise tax will be in addition to the disqualified individual's existing federal and state income taxes and FICA tax.) An example of the application of the excess parachute payment calculation is set forth in Example 2 below.

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[10] Q/A-24(b).
[11] Q/A-25.
[12] Q/A-26.
[13] *See also* Q/A-38.

ISSN 0747-8607

Example 2—Excess Parachute Payments

Assume the same facts as in Example 1, except that Employee B receives $2,000 more in parachute payments than Employee A (i.e., Employee B receives parachute payments equal to $451,000, and Employee A receives parachute payments equal to $449,000). Under these facts, Employee B incurs $60,200 in parachute payment excise taxes. Likewise, the additional $2,000 in parachute payments to Employee B will cause the employer to lose approximately $93,000 in federal income tax deductions (because the additional $2,000 in parachute payments to Employee B will result in $301,000 in excess parachute payments). Consequently, §280G only allows the employer to deduct $150,000 of the $451,000 payment made to Employee B. This example underscores the importance of carefully identifying parachute payment amounts and suggests how some thoughtful strategic planning can create substantial value to both the executive and the employer.

Example 2 – Excess Parachute Payments Calculation

Facts	**Employee A**	**Employee B**
• Base Amount (5-Year Average Compensation)	$150,000	$150,000
• Contingent Parachute Payments (Payments accelerated or paid by reason of change in control)	$449,000	$451,000
• 3 Times Base Amount Limit (Safe-harbor Amount)	$450,000	$450,000
• Any Parachute Payment in excess of safe-harbor amount?	**No**	**Yes**
• Total Excess Parachute Payments (Amounts above 1x Base Amount, assuming safe-harbor amount is exceeded)	$0	$301,000
• Application of 20% Excise Tax (Code §4999)	$0	$60,200
• Net Parachute Payment (after Excise Taxes, before Federal/ State Income Taxes)	$449,000	$390,800
• Employer's Parachute Payment Deduction	$449,000	$150,000
• Cash Value of Employer's Lost Federal Income Tax Deductions (31% tax bracket) –[(.31 × ($450,000−$150,000)]	$0	$93,000

VALUATION OF STOCK OPTIONS — REV. PROC. 2002-13

One of the more challenging questions for practitioners under the 1989 proposed regulations was how to determine the value of compensatory stock options under circumstances where vesting is accelerated by reason of a change in control. The 1989 proposed regulations provided that the value of a stock option with an ascertainable fair market value at the time the option vests was determined under all of the facts and circumstances in the particular case. Factors relevant to the determination included the difference between the current share price (''spot price'') and the option's exercise price (''strike price''), the probability of the value of such property increasing or decreasing, and the length of the period during which the option could be exercised.[14] Most practitioners, however, concluded that assumptions for future growth were *not* determinable and simply set the value at the ''spread'' of the options, or the difference between the spot price and the grant price (''spread methodology'').

With release of Rev. Proc. 2002-13, the IRS provided guidance for valuing stock options. Rev. Proc. 2002-13 provides that stock options can be valued using any valuation method that is consistent with generally accepted accounting principles (specifically, Black-Scholes or the binomial method). Assumptions under the Black-Scholes methodology need to qualify under the guidelines specified in Rev. Proc. 98-34,[15]which addresses the valuation of compensatory stock options. As an alternative, the IRS published a safe-harbor table within Rev. Proc. 2002-13 that is based on Black-Scholes calculations. Subsequently, Rev. Proc. 2002-45 modified Rev. Proc. 2002-13 by noting that the spread methodology is an improper valuation method and revising the existing safe-harbor table to address practitioners' suggestions that the prior table did not consider all of the relevant facts and circumstances necessary for valuing a stock option. The modified safe-harbor table under Rev. Proc. 2002-45 provides a simpler method for valuing options, as compared to the more technical Black-

[14] Q/A-13.

[15] 1998-18 I.R.B. 15.

ISSN 0747-8607

Scholes or binomial valuation methods. This modified approach, however, may not always lead to the most favorable results for employers or their executives.

Example 3 illustrates the methods for valuing stock options under the 1989 proposed regulations as well as under the revisions promulgated by Rev. Procs. 2002-13 and 2002-45. It is noteworthy that the use of the Black-Scholes valuation method in the example allows an executive to reduce his or her parachute payment amount by over $500,000, as compared to using the safe-harbor tables set forth in Rev. Proc. 2002-45. In both cases, however, Rev. Proc. 2002-13 results in a greater financial value being assigned to accelerated stock option vesting than existed under the 1989 proposed regulations.

Example 3 – Stock Option Valuation Methodologies

	Prior Guidance	New Guidance (Either Method)	
	1989 Proposed Regulations-(Spread Method)	Black-Scholes Method (Rev. Proc. 98-34)	Use of Safe Harbor (Rev. Proc. 2002-45)
Value of Accelerated Vesting of Stock Options	$1,000,000	$1,245,841	$1,797,000

Assumptions

- 100,000 Nonqualified Stock Options Granted on 1/1/2000; Grant Expires on 1/1/2010
- $20.00 Grant Price
- $30.00 Current Share Price
- Date of Change in Control –12/31/2002 (84 months until options expire)
- FAS 123 Expected Dividend Yield – 2%
- FAS 123 Volatility - .31 (Medium Volatility for Safe Harbor Table)
- FAS 123 Weighted Average Future Lifetime - 5 Years
- Risk Free Rate of Return – 5.0%
- Assume Option Grant Vests 100% after 5 Years
- Options Fully Vest upon a Change in Control

Generally, the safe-harbor method results in the highest stock option values being added to the payments triggered by a change in control or, in other words, the least favorable results to the executive and the employer. Such a result, however, will not always be the case. Consequently, as an employer attempts to evaluate its executives' obligations under the parachute payment rules, there may be a significant advantage to assessing the impact of accelerated stock option vesting under each of the methodologies identified above. Such an effort can yield some very significant financial benefits to both the executive and the employer and will serve to minimize any excise taxes under §4999.

CONTRACTUAL ARRANGEMENTS

Many employers have entered into written employment or termination arrangements with senior executives in anticipation of a possible future change in control of the corporation. While these arrangements can vary in terms of their complexity, many will likely include some form of accelerated cash payment or equity-based compensation award that becomes available at the time of the change in control. These agreements often have provisions, however, that will limit the amount of payments (more specifically, the amount of parachute payments) that the executive will receive upon a change in control. In our experience, executives and employers oftentimes do not know whether or how these contractual provisions will apply and what financial effect, if any, they will have on the employer or its executives. To the extent that such agreements exist, they often take one of three forms: a tax gross-up, a more popular 2.99 parachute payment cap, and a blended approach. While the variations in change in control contractual designs are beyond the scope of this article, it is important for the reader to recognize that while such arrangements have become fairly common, they are rarely fully appreciated by employers or their executives. These three arrangements are briefly described below, along with an example of the surprising financial impact that the tax gross-up provision can have on an unprepared employer.

- ***Tax Gross-Up*** — Under this strategy, employers contractually agree that, to the extent that the executive is subject to excise taxes under §4999, the employer will gross-up the executive's compensation to cover such excise taxes. The three primary forms of tax gross-ups cover: (1) all taxes (federal, state, local, FICA and Code §4999 excise taxes); (2) a one-time payment of taxes; and (3) a limited amount to cover unanticipated taxable amounts. Overall, the intent of tax gross-up provisions is to enable an executive to receive the ''net contractual payments;'' because a tax gross-up payment is considered an additional parachute payment, the gross-up amount also serves to further increase the excess parachute payment amount and, thus, the excise tax. Ultimately, an employer ends up grossing-up the executive for the additional excise taxes attributable to the original gross-up payment. To illustrate the significant financial impact such a provision can have on an employer, we have used the facts from Example 2

ISSN 0747-8607

(with respect to Employee B) above to illustrate this result. As will be seen, this provision amounts to a further payment (in addition to the normal change in control payment) by the employer of $753,578.

Example 4 – Tax Gross-Up Financial Impact	
Parachute Payments	$451,000
Tax Gross-Up Payments	$753,578
Total Parachute Payments (“TPP”)	$1,204,578
Estimated Taxes	
Federal Income Taxes (38.6% of TPP)	$464,967
State Income Taxes (5% of TPP)	$60,229
FICA Taxes (1.45% of TPP)	$17,466
IRC §4999 (20% of TPP in excess of 1x Base Amount = 20% × ($1,204,578 − $150,000))	$210,916
Total Taxes	$753,578
Net Parachute Payments (After Taxes)	$451,000

- ***Parachute Payment Caps*** — In recognition of the potentially significant costs associated with tax gross-up payments, it is not surprising that tax gross-up provisions are normally only found at the most senior levels of an employer. More likely is the situation where the employer applies a parachute payment cap in its agreement with the executive. A parachute payment cap provides that an executive will receive parachute payment amounts not to exceed 2.99 times the executive’s base amount. This approach is intended to completely eliminate the possibility of incurring excise taxes under §4999 of the Code by insuring that the parachute payment amount will never equal or exceed three times the executive’s base amount. Such a provision, moreover, enables the employer to deduct 100% of the compensation payments to the executive following the change in control. Unless the executive fully understands the application and ramifications of such a provision, however, he or she may end up receiving far less in compensation than what he or she may have expected under his or her employment or change in control arrangement.

- ***Blended Approach*** — This approach, which is less popular, applies the excess parachute payment cap only if the executive’s net after-tax payment is greater by applying the 2.99 cap than would result if the cap was not applied. The employer does not “gross up” the executive for any taxes under this approach.

STRATEGIES TO MITIGATE OR ELIMINATE PARACHUTE PAYMENT TAXES

The possible financial impact of excess parachute payments should be carefully evaluated well in advance of a change in control. Even as a change in control approaches, however, it is still possible to consider tax-planning opportunities. Disqualified individuals may receive payments contingent upon a change in control that, after the application of the parachute taxes, are substantially less than the amount that the executives may have expected and, in some cases, far less than if the change in control did not occur. For the employer, failure to consider parachute payment strategies can result in the loss of substantial corporate tax deductions. Thus, careful strategic planning, which may continue to take place even after the change in control has been announced, can yield significant financial benefits to both executives and their employers.

The remainder of this article discusses several possible alternatives to reduce excess parachute payments (without adversely impacting executives’ net change in control payments). These strategies are designed to, among other things, mitigate any excise taxes (and loss of employer tax deductions) that may occur in connection with a change in control. The viability of the different planning opportunities requires a careful examination of the various elements comprising the executive compensation paid or payable both prior to and following the change in control. In assessing possible alternatives, however, it is important that the employer not lose sight of the objective of providing financial protection to its executives in the uncertain times likely to exist at the time of a change in control. Consequently, alternatives must be attractive to both the employer and the executive, as well as cost-effective, and must also be consistent with the provisions of §280G and related technical pronouncements.

- **Strategy: Evaluate Compensation Payable to the Executive.** In general, reasonable compensation paid before or after a change in control is not included in calculating the total parachute payments to an executive, provided that such amounts are not con-

ISSN 0747-8607

ditioned on the change in control event and shown to be reasonable by clear and convincing evidence. Question & Answer 3 of the 2002 proposed regulations sets forth a basis to support the reasonableness of certain compensation payments. The proposed regulations would permit, for example, evidence demonstrating that such payments are in line with the payments received by other executives having similar responsibilities within the same industry or that the payments are generally comparable to the compensation historically received by the executive for such services.

For periods following a change in control, compensation will be deemed reasonable and, thus, *not* considered as a parachute payment if, as described in Question & Answer 42 of the 2002 proposed regulations, the executive's annual compensation is not significantly greater following the change in control than it was immediately before, and provided that the disqualified individual's duties and responsibilities remained substantially the same. If the duties and responsibilities have changed significantly, the disqualified individual's annual compensation must not be significantly greater then the annual compensation paid by the employer to comparable executives performing similar duties. Consequently, at the outset of evaluating possible parachute payments, the timing, description and method of paying compensation (both before or after a change in control) should be carefully reviewed and supportable by prior practice and records.

- **Strategy: Increasing the Base Amount.** To the extent that an executive is in position to increase his or her base amount in the year prior to the year of a change in control, such increases can yield substantial financial benefits to both the executive and the employer. (Because an executive's safe harbor amount under the parachute payment rules cannot equal or exceed three times his or her base amount, the more that we can increase the base amount, the greater will be the amount of the safe harbor.) Base amounts can be increased in a number of ways, including electing to receive a payment of nonqualified deferred compensation in the year prior to the year of the change in control (to the extent the deferred compensation plan allows), exercising nonstatutory stock options, having the restrictions lapse on restricted stock or other forms of equity-based compensation, or paying bonuses in the year prior to the year of the change in control. To the extent a plan or agreement modification or any base amount increase is first developed or is found to have been adopted or implemented contingent on the change in control (or within one year of the change in control), it will be presumed to be a parachute payment. This strategy may still have some appeal to the extent that it results in a significant increase to the base amount (by the inclusion of these amounts in the executive's taxable income). In order to take advantage of this strategy, however, it is critical that the employer put the change in place (i.e., make the payments) by the end of the calendar year prior to the calendar year during which the change in control will occur. Obviously, the further in advance of a change in control that an employer evaluates its alternatives, the more likely that it will be in position to implement such a change in control strategy.

- **Strategy: Cash-Out Stock Option Gains.** For purpose of the parachute payment rules, nonstatutory stock options that become vested or exercisable by reason of the change in control must be valued by the safe harbor, Black-Scholes or binomial method. One approach to minimize the value that stock options will add to the executive's parachute payment amount is to immediately "cash-out" the nonstatutory stock options when they vest or become exercisable. This strategy will eliminate calculating the future value of the options which can, based on financial assumptions and projections, increase parachute payment amounts significantly. The only portion of the nonstatutory stock option includible as a parachute payment under such circumstances will be the difference between the spot value and the strike price, i.e., the intrinsic value. This approach is analogous to how practitioners generally treated nonstatutory stock options under the 1989 proposed regulations. (By exercising the options, however, an executive loses the potential for future stock growth and incurs immediate taxable income that may not receive capital gains treatment. If the stock is publicly traded, the individual can, of course, repurchase the shares on the market.) Obviously, this approach to avoid application of the future value associated with valuing stock options should be carefully considered in light of expectations regarding future stock growth. Accounting implications that may result if the stock option plan does not permit the immediate ex-

ISSN 0747-8607

ercise or ''cash-out'' of the option at the time of the change in control should also be evaluated.

• **Strategy: Design Program to Provide for Excludible Payments.** Although parachute payments may include many forms of compensation, payments made from qualified retirement plans are excluded.[16] Consequently, employers may want to evaluate the various source of payments made to executives — indeed, employers may also want to consider designing a program that can put compensation into the hands of its executives without triggering any liability under the parachute payment rules. For example, to the extent an employer's qualified defined benefit plan has excess assets, consideration may be given to amending the plan to provide enhanced benefits to employees following a change in control. While any such amendments would be subject to nondiscrimination rules and would likely need to cover a fair cross-section of employees, there are some nondiscrimination testing techniques that may permit qualified plan benefits to accrue for executives at more favorable rates than other employees.

Similarly, when a newly hired executive proposes to enter into an employment agreement with the employer, it is important to consider some planning opportunities and to have the agreement drafted with great care and precision to detail. More specifically, any payment under an employment agreement that is made to replace benefits that the executive may have given up when he or she left his or her former employer are excluded from the parachute payment calculations. Thus, to the extent that the employment agreement indicates that specific payments are in recognition of foregone payments or benefits from a former employer that have been lost by reason of the change in employment, such payments and benefits would be excluded from the parachute payments even if the arrangement is executed within one year of the change in control (by reason of the payments representing remuneration for past services).

• **Strategy: Covenants Not To Compete.** After they have reviewed and analyzed the amount and form of payments, have considered several strategies to allocate payments to past or presently provided services, and have maximized the base amount used for determining the safe harbor amount, employers may consider allocating a portion of the remaining change in control payments to the executive's services to be performed (or not performed) following his or her termination of employment following a change in control. This is often accomplished through the use of covenants not to compete. Because certain contractual payments can be allocated to a disqualified individual's agreement not to compete against an employer in the future, they can be excluded from the parachute payments as reasonable compensation for services *not* to be performed following the change in control. This approach can be a very effective strategy for minimizing or eliminating the risk of an executive receiving excess parachute payments. Questions & Answers 11 and 42 of the 2002 proposed regulations require that this strategy be supported by clear and convincing evidence that: (1) the executive's future ability to compete against the employer is substantially constrained; (2) there is a reasonable likelihood that the employer will enforce the agreement; and (3) the consideration for the non-compete agreement qualifies as ''reasonable compensation'' under the parachute payment rules.

The use of non-compete provisions in this context is very fact-specific. It is important to note that, although a non-compete provision may appear to satisfy the parachute payment criteria on its face, the non-compete restrictions may fall short where, for example, the executive is of an age where returning to the workforce in a similar capacity appears unlikely, or in situations where the covenant not to compete may not be enforceable in the executive's state of residence (for example, the State of California may not generally enforce such agreements based on statutory and public policy reasons). Thus, the underlying facts surrounding use of a non-compete agreement must be carefully examined before assigning a portion of the post-change in control payments to such non-compete provision.

Before assigning a financial value to covenants not to compete within the context of a change in control or employment arrangement, there are a number of factors impacting the value that must be considered and carefully evaluated including:

- **Market Impact** — Evaluate the executive's likelihood of working and contributing to an industry competitor after terminating service. This should include developing financial data to support the executive's position within the industry and the likely financial impact he or

[16] Q/A-42.

ISSN 0747-8607

she may have on the employer if he or she were to be employed by a competitor in the industry. An example of information that would support the value of the covenant not to compete could include the financial impact to the employer if the executive were in position to move large clients/business relationships to a competitor;

- **Prior Business Development** — Qualify if not quantify the executive's contribution to the employer's historical business and technological developments and the associated market value resulting from such developments for periods prior to the change in control; and

- **Executive's Personal Situation** — Consider the executive's age, financial wealth, public statements of future business intentions and the executive's industry-specific knowledge.

For the example below, assume that the non-compete agreement runs for a one-year period and that the amount of post-change in control payments (reasonable compensation) attributable to the non-compete provision is $150,000.

Example 5 – Covenant Not To Compete		
Financial Assessment	Executive B (See Example 2 – No Non-Compete)	Executive B (Including Value of Non-Compete)
• Parachute Payments (See Example 2)	$451,000	$451,000
• ''Reasonable Compensation'' Assigned to Non-Compete Agreement	$ 0	$150,000
• Parachute Payments (After Consideration of Non-Compete Agreement)	$451,000	$301,000
• Any Excess Parachute Payments?	**Yes**	**No**
• Excess Parachute Payment Amounts	$301,000	$0
• Application of 20% Excise Tax Paid by the Executive	$60,200	$0
• Net Parachute Payment Amount (After Excise Taxes, Before Income Taxes)	$390,800	$451,000
• Employer's Parachute Payment Deductions	$150,000	$451,000
• Cash Value of Employer's Lost Federal Income Tax Deductions (31% tax bracket) –[(.31 × ($450,000-$150,000)]	$93,000	$0

In summary, it is imperative that: (1) the language of the non-compete agreement reasonably constrain the executive from competing against the employer in the future; (2) facts support the employer's history of enforcing such provisions; and (3) such agreement is enforceable in the applicable jurisdiction or locality.

• **Strategy: Consider Impact of §83(b) Elections.** Frequently, an executive will make a Code §83(b) election upon receiving an award of, for example, restricted stock. (Normally, in the absence of a §83(b) election, federal income taxes are due when the restriction on the stock lapses.) Section 83(b) elections permit the executive to take into taxable income the fair market value of a stock award at the time of the grant of the award and pay federal income tax at that time. Because the §83(b) election permits the executive to pay federal income tax at the time of the award, federal income taxes will not be due at the time the restrictions lapse; capital gains taxes (short or long-term) are payable once the stock is later sold by the executive.

The net income tax result to the executive from making a §83(b) election can be quite beneficial. The executive only recognizes a small amount of income at the time of the §83(b) election (because the value of the stock may be nominal at the time of the award). As a result of the §83(b) election, the executive pays potentially less (perhaps significantly less) federal income taxes at the time of the award of the restricted stock than he or she would pay if taxes were paid at the time the restrictions on the stock award lapse.

For purposes of the parachute payment calculations, PLR 9822029 provides that income associated with a §83(b) election is includible as compensation

ISSN 0747-8607

for purposes of determining the base amount under the parachute payment rules in the year that the §83(b) election is made. The lapse of restrictions in a later year does not serve to increase the base amount in such later year. Thus, a §83(b) election typically results in only a very small amount being included in the executive's base amount for purposes of calculating the parachute payment safe harbor amount. While this may be beneficial from the standpoint of the executive minimizing income taxes at the time the restrictions on the stock award lapse, the §83(b) election can eliminate some planning opportunities under the parachute payment rules. For small start-up companies, for example, only a de minimis amount of income may be initially realized by the executive following a §83(b) election. From the perspective of the parachute payment rules, however, the electing executive will not be able to take the value of the restricted stock into his or her base amount in the year prior to the year of the change in control, assuming the stock award plan would have provided for the stock restrictions to lapse in a year prior to the change in control (because the stock award value was already recognized in the year of the §83(b) election). Consequently, the executive who has made a §83(b) election is likely to have a significantly smaller base amount (for parachute payment purposes) than an executive who may have his or her stock awards vest (or the restrictions lapse) in a year prior to the year of the change in control.

In evaluating the use of §83(b) elections, it may not be possible to anticipate a change in control and the existence of parachute payments early enough to help the executive to evaluate which alternative yields the best financial results. Does the executive benefit more by paying federal income taxes at the time of the award (and not when the restrictions on the award lapse), or does the executive benefit more under the parachute payment rules by not making the §83(b) election and taking the value of the restricted stock into income (depending on the terms of the restricted stock award) in the year prior to the year of the change in control? To the extent an employer is planning a sale of the business in the future, the tax planning opportunities under Code §§83(b) and 280G should be carefully compared and evaluated.

- **Post-Change in Control Agreements.** Under the parachute payment rules, there is a presumption that any payment authorized by an agreement that is executed within one year before a change in control (or an extension of such an agreement during the same period) is a parachute payment. Employers, however, are permitted to rebut such presumption by clear and convincing evidence, including information to support the reasonableness of the post-change in control compensation. If the executive and the employer enter into an agreement after a change in control (that is not pre-arranged prior to the change in control or an amendment to a pre-change in control agreement), any payments paid under the post-change in control agreement will be excluded from the parachute payment calculations.

- **Strategy: Reasonable Compensation Following Contract Termination.** In view of the negotiations that surround change in control transactions, it is not unusual for there to be negotiations with executives of the acquired company in connection with their future employment prospects at the newly merged company. If an executive has an employment contract with his or her employer, the executive may need to negotiate or even litigate in order to receive certain contractual payments. Depending on the circumstances surrounding such negotiations, it may be possible to have the payments characterized as contract damages to be collected by the executive. Although the payments (damages) may be paid shortly after the change in control, Question & Answer 42 of the 2002 proposed regulations indicates that an executive may attribute certain payments to contractual damages for reasonable compensation to be paid for personal services to be rendered on or after the change in control if the following factors are shown to exist: (1) the employment contract was not entered into or amended in contemplation of the change in control; (2) the amount of compensation would be treated as reasonable compensation assuming it was an ordinary and necessary business expense under the Code; (3) the damages do not exceed the present value of the compensation the executive would have received under the employment contract had the executive continued to perform services until the end of the contract term; (4) the damages are received because an offer to provide personal services was made by the executive but was rejected by the employer; and (5) the damages are to be reduced by mitigation (i.e., to the extent the executive obtains other employment during the original contract term).

ISSN 0747-8607

- **Strategy: Other Actions.** The number of variations to the strategies discussed above are endless. In general, to the extent the executive (or the employer) is in position to increase his or her base amount in the year prior to the year of the change in control (subject to plan terms and constructive receipt rules), such adjustments can yield substantial benefits under the parachute payment rules. Other variations may include, for example, increasing forms of compensation includible in the executive's base salary (for example, receiving a raise in the year before the change in control), making disqualifying dispositions of incentive stock options (and then exercising the newly created nonqualified options), as well as ceasing any further deferrals under any nonqualified deferred compensation plan, subject to a careful evaluation of the constructive receipt rules.

CONCLUSION

Change in control transactions require that all of an executive's efforts be devoted to evaluating the financial impact of the transaction on shareholders and assessing the implications of the transaction on the business of the employer. While parachute payments may appear small in comparison to the financial impact of the overall transaction, they are likely to be quite important to the executives involved in the change in control transaction. In addition, the payments to executives are likely to have significant financial implications to the employer, not only in terms of the amount it may pay and deduct under the parachute payment rules, but also in terms of having the resulting management team focused on integrating the businesses and acting in the best interests of shareholders. While it is obviously best to evaluate the application of the parachute payment rules to executive arrangements well in advance of any change in control transaction, there continue to remain some very attractive parachute payment planning opportunities that may be undertaken once the announcement of the change in control has occurred.

To the extent that employers want to maximize the deductible compensation paid to executives and provide executives change in control benefits in the most tax-efficient manner possible, employers need to review their alternatives and act quickly to determine the most tax and financially efficient approach for their executives.

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