



Jul 06, 2019

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Authors:

[Scott W. Dolson](#)

[Carl C. Lammers](#)

Addressing the Impact of the Golden Parachute Rules in M&A Transactions

A “golden parachute” is defined as an agreement between an employer and employee that triggers a significant compensation payment as a result in a merger, M&A transaction or other change-in-control event. Regulatory concerns over excessive change-of-control payments dates back to the 1990s when Congress added provisions to the Internal Revenue Code limiting an employer’s deduction for excess golden parachute payments and imposing an excise tax on the employee. Roll forward to 2019 and the threat of a 20% additional tax imposed on the management team’s excess golden parachute payments ranks high on their list of concerns during a sale process.

The best time to begin planning for minimizing the tax impact of excess golden parachute payments is when compensation packages are first structured and negotiated. Later when a sale process is looming or underway, the management team and owners can often take steps to mitigate the potential impact of IRC §§ 280G and 4999. Although the golden parachute excise tax has the greatest impact on management team, the provisions also impact the target company and the buyer.

M&A Transaction Planning

There are several strategies available to reduce the potential impact of Section 280G prior to and during a sale process:

- **Increase pre-sale annual compensation.** An effective strategy is to increase an executive’s compensation during the five-year period prior to triggering a change in control. The higher the compensation base amount, the less likely there will be excess parachute payments.
- **Obtain shareholder approval.** A private company can avoid the impact of

Section 280G by obtaining shareholder approval of the excess parachute payments. Shareholders holding at least 75% of the

target company's voting equity must approve the compensation payments immediately prior to the applicable Section 280G triggering event (e.g., sale of assets or stock). Shareholder approval must not be automatic or a condition of the sale transaction. Prior to the vote, the target company must adequately disclose the material facts concerning the payments and benefits along with the adverse tax consequences to both the affected individuals and the target company.

There can be no advance agreement to lock up votes in favor of shareholder approval. Finally, and most significantly, the affected employees must agree in advance of the vote to waive the excess parachute payments if shareholder approval is denied.

Understandably, pursuing the shareholder vote option can be a bit nerve racking for the employees. As a practical matter, shareholders generally understand that an important aspect of a successful sale is a happy management team, and as a result for shareholders to withhold their approval of the excess parachute payments.

Typical provisions in M&A agreements

A buyer purchasing a C corporation's stock (i.e., inheriting the C corporation's tax and compensation obligations) wants to avoid a situation where the acquired company is obligated to make nondeductible compensation payments or is obligated to gross-up an executive's compensation to cover the 20% excise tax. As a result, most definitive agreements will include representations confirming that there will be no excess parachute payments triggered by the sale transaction and/or a covenant requiring the target company and its executives to seek shareholder approval of the excess parachute payments.

Since employees must agree in advance to waive the excess parachute payments if shareholder approval is denied, the buyer knows that whether or not shareholder approval is obtained, the Section 280G problem has been eliminated. The definitive agreement should not include a closing condition specifically requiring a favorable shareholder vote, but there can be a closing

condition requiring that shareholders consider approval of the excess parachute payment, which effectively means that at closing either the excess parachute payments will have been approved or waived by the affected employees.

The target company's owners also benefit from obtaining shareholder approval of the excess parachute payments, since purchase agreements can include an offset against the purchase consideration for the value of lost tax deductions due to Section 280G or a purchase price reduction for any gross-up obligations.

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