What M&A Transaction Participants Need to Know About the Golden Parachute Rules

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A "golden parachute" is defined as an agreement between an employer and employee that triggers a significant compensation payment as a result in an M&A transaction or other change-in-control event. Regulatory concerns over excessive change-in-control payments date back to the 1990s when Congress added provisions to the Internal Revenue Code (the "Code") limiting an employer's deduction for excess golden parachute payments and imposing an excise tax on the employee.

Roll the clock forward to 2019, and the golden parachute tax penalties remain a significant concern for those structuring executive compensation arrangements as well as business owners and buyers involved in M&A transactions. Understandably, the threat of a 20% additional tax imposed on the management team's excess golden parachute payments[1] ranks high on their list of concerns during a sale process.

The best time to implement strategies 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 Code Sections 280G and 4999. Although the golden parachute excise tax has the greatest impact on the management team, the provisions also impact the target company and the buyer.

Golden Parachute Basics

Section 4999 provides that employees or independent contractors [2] receiving excess parachute payments, as defined in Section 280G, are personally responsible for paying a nondeductible 20% tax on those excess payments, in addition to other applicable income and employment taxes. Employers also lose their tax deductions for the amount of the excess parachute payments. The

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terms of the definitive agreement will dictate whether the seller or buyer is responsible for any gross-up provision in an executive's compensation package. The applicability of Section 280G is usually addressed in tax representations and tax indemnity clauses in the definitive agreement.

Section 280G applies only to C corporations that are not eligible to make an S election. An asset sale, stock sale, or taxable merger of an employer can trigger Section 280G. The excise tax applies to compensation payments that are triggered by M&A transactions resulting in a change-in-control. An employee's parachute payments can include transaction bonuses, severance pay, the Section 280G value of accelerated stock options, restricted stock awards and other equity compensation, and certain signing bonuses, retention bonuses and buyer equity awards. An employee has an excess parachute payment amount if the present value of his parachute payments equals or exceeds three times the "base amount" of his compensation. The "base amount" of compensation is an employee's average annual compensation for the most recent five taxable years preceding the M&A transaction year.[3] Even $1.00 over the Section 280G threshold will create a large tax burden, because the excise tax then applies to every dollar over a one-year average compensation amount.

When Section 4999 is triggered, the 20% excise tax is levied on the excess of an individual's compensation triggered by the M&A transaction over his "base amount." For example, if an employee's base amount is $500,000, and his aggregate parachute payments are $2,000,000, then he would have an excess parachute payment because his aggregate parachute payments exceed three times his base amount. Once triggered, the 20% excise tax would be levied against the employee's excess parachute amount of $1,500,000 ($2,000,000 – $500,000). Employees with a low base amount are particularly at risk under the golden parachute rules. Low base amounts can result from recent rapid increases in compensation or the generous use of options or other non-taxable compensation awarded in the place of compensation that would be included in the base amount.

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Parachute payments don't include reasonable compensation for services actually rendered on or after the date of the change of control. Reasonable post-closing compensation can include either or both payments for services and noncompetition payments. The golden parachute rules are much more detailed and complicated than suggested by the summary outlined above. Business owners and the management team should have their tax advisors assess Section 280G's potential impact long before the commencement of the sale process.

How does one address the problem of golden parachute payments in the compensation agreement drafting process?

Many employers include provisions dealing with Section 280G in compensation-related agreements such as employment agreements and bonus plans. These provisions generally fall into one of several categories. Executives may agree that they will not receive an amount that would constitute an excess parachute payment, which effectively caps the value of what they can receive at 2.99 times their base amount.

Other executives might agree to a "better of" cap, providing that excess parachute payments will be reduced only to the extent that the excess would reduce the net after-tax amount of the executive's compensation. Finally, employers might agree to gross up the executive's compensation to offset the tax effect of the 20% excise tax, but this approach is increasingly uncommon due to the expensive nature of gross-up payments. The method chosen often depends on the relative bargaining positions of the employer and employee.

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.

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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.

A good understanding of the technical rules of Section 280G is critical.

There are numerous nooks and crannies in the Section 280G rules and regulations that can have a material impact on the calculation and application of Section 280G. For example, a parachute payment can result from pre-existing stock options, restricted stock units, restricted stock or other property if the property vests in connection with a Section 280G triggering event, regardless of when exercise actually occurs and regardless of whether a Section 83(b) election was previously made. As a result, it is possible that the 20% excise tax could be payable in the year that a Section 280G triggering event occurs, even though payment occurs in a later year.

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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 whether or not shareholder approval is obtained, and 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.

Carl Lammers has substantial experience in representing employers on employee benefits and executive compensation matters. For more information on this topic, please feel free to contact Carl at clammers@fbtlaw.com.

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[1] Section280G sets forth the golden parachute rules and Section 4999 imposes the 20% additional tax on the excess parachute payments.

[2] Section 280G applies to "disqualified individuals" which means service providers who are either 1% shareholders, a person with

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officer-like responsibility or “highly-compensated individuals” (basically in top 1% when ranked by pay)

[3] Usually, the executive’s annual compensation equals his compensation reported in Box 1 of Form W-2 or Box 7 of an independent contractor’s Form 1099-MISC.

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