Golden Parachute Payments in M&A Transactions

This edition of A Few Things You Should Know concerns Section 280G of the Internal Revenue Code (the “golden parachute payment” rules). We provide a high-level summary of key Section 280G rules and discuss how Section 280G typically arises in M&A transactions.

WHY DO PARTIES IN M&A TRANSACTIONS CARE ABOUT SECTION 280G?
Sensitive issues can arise during M&A transactions regarding Section 280G. If Section 280G is triggered, the individual employee (or independent contractor) receiving compensation subject to Section 280G is personally responsible for paying a nondeductible 20% excise tax on any “excess parachute payments” (in addition to income and employment taxes that normally apply to such compensation), and the employer corporation making such payments to the employee (or independent contractor) is not allowed to claim a tax deduction for the excess parachute payments. The excess parachute payments are reported on the employee’s Form W-2 (or independent contractor’s Form 1099), and the employer corporation making such payments must withhold the 20% excise tax in the same manner it uses to withhold federal income taxes.

WHEN DOES SECTION 280G APPLY?
Section 280G generally applies in the acquisition of a target corporation (including both privately and publicly held corporations) if there are “parachute payments.” The term “parachute payment” is defined under Section 280G with a number of terms of art and generally means any compensatory payment that:

- is made to a “disqualified individual”;
- is contingent on a change in the “ownership” or “effective control” of an entity classified as a corporation for federal tax purposes or in the ownership of a “substantial portion” of the assets of such corporation; and
- has (together with all other potential parachute payments with respect to the disqualified individual) an aggregate present value that equals or exceeds three times the individual’s “base amount.”

TRANSACTIONS TRIGGERING SECTION 280G
Section 280G contains technical rules for determining whether a change in the “ownership” or “effective control” of a corporation, or a change in the ownership of a “substantial portion” of the assets of a corporation, has occurred. Generally, the terms are defined as follows:

- **Ownership.** An acquisition by one person (or persons acting as a group) of more than 50% of the total fair market value or total voting power of the stock of the target corporation.

- **Effective Control.** Subject to a rebuttable presumption, (a) an acquisition during a 12-month period by one person (or persons acting as a group) of 20% or more of the total voting power of the stock of the target corporation, or (b) the replacement of a majority of members of the corporation’s board of directors during any 12-month period by directors whose appointment or election is not endorsed by a majority of the previous members of the corporation’s board of directors.

- **Substantial Portion of Assets.** An acquisition during a 12-month period by one person (or persons acting as a group) of the assets from the target corporation that have a total gross fair market value (without regard to any liabilities) equal to or more than one-third of the total gross fair market value of all of the assets of the corporation immediately prior to the acquisition.
All members of the same consolidated group of corporations (as determined in accordance with the Section 280G rules) are treated as a single corporation. For example, if a target corporation is the parent of a wholly owned subsidiary corporation and the target corporation sells all of its stock of the subsidiary corporation and other assets (“transferred assets”) to an unrelated third party in a “carve out” transaction, Section 280G would not apply to either the target corporation or the subsidiary corporation if the total gross fair market value of the transferred assets were less than one-third of the total gross fair market value of all of the assets of the target corporation group immediately prior to the acquisition. On the other hand, if the transferred assets constituted one-third or more of the total gross fair market value of all of the assets of the target corporation group immediately prior to the acquisition, Section 280G would apply to both the target corporation and the subsidiary corporation.

Section 280G generally will not apply to the following types of transactions.

- An acquisition of a partnership or a limited liability company treated as a partnership for federal tax purposes.
- An acquisition of a target corporation that, immediately before the acquisition, could have made an election to be treated as an S corporation for federal tax purposes.

**DISQUALIFIED INDIVIDUALS**

Section 280G applies only to “disqualified individuals.” Disqualified individuals generally are employees (or independent contractors) who, at any time during the 12-month period prior to and ending on the closing date of the acquisition, have been officers of the corporation, shareholders owning more than 1% of the outstanding shares of the corporation’s stock, or highly compensated individuals of the corporation, as well as members of the corporation’s board of directors who fall under one or more of these three categories. Section 280G contains a number of technical rules for identifying a corporation’s disqualified individuals.

**COMMON TYPES OF COMPENSATORY PAYMENTS THAT TRIGGER SECTION 280G**

Compensatory payments that are contingent on the consummation of an acquisition are taken into account for purposes of determining whether Section 280G is triggered. In general, a payment is treated as contingent on the acquisition if the payment would not, in fact, have been made had no acquisition occurred. Unless the contrary is established by clear and convincing evidence, a payment is presumed to be contingent on an acquisition if the payment is made pursuant to an agreement (or an amendment to an agreement) entered into within the one-year period before the date of the acquisition.

Examples: Compensatory payments that are commonly taken into account include the following.

- Change-in-control bonus payments made as a result of the consummation of the acquisition (e.g., payments under management carve-out programs).
- Severance pay that is payable as a result of termination of employment shortly before or after the acquisition.
- The Section 280G “value” of acceleration of vesting of stock options, restricted stock awards, and other equity-based awards in connection with the acquisition.
- Certain types of post-closing payments and benefits (such as signing bonuses, retention bonuses, and post-closing equity awards that are not comparable to what similarly situated employees at the buyer receive).

**BASE AMOUNT**

A disqualified individual’s “base amount” generally equals the individual’s average annual compensation from the target corporation for the most recent five taxable years preceding the taxable year in which the acquisition occurs (or such lesser number of years during which the individual performed services for the target corporation). A disqualified individual’s “annual compensation” for a given taxable year generally will equal the amount of compensation reported in Box 1 of the employee’s Form W-2 (Box 7 of an independent contractor’s Form 1099-MISC).
EXCESS PARACHUTE PAYMENTS
If Section 280G is triggered, the amount of a disqualified individual's total "excess parachute payments" generally will equal the amount of all of the individual's compensatory payments that are contingent on the acquisition, minus the individual’s "base amount" (i.e., one times the individual’s base amount, not three times).

Example: Assume that, in connection with an acquisition, an executive receives a change-in-control bonus in the amount of $1,000,000 and the executive’s base amount is $200,000. Section 280G would be triggered because the aggregate amount of the executive’s compensatory payments ($1,000,000) exceeds three times the executive’s base amount ($600,000). The total amount of the executive’s "excess parachute payments" would be $800,000 (calculated as follows: $1,000,000 minus $200,000 (which is the executive’s base amount)), and the 20% excise tax would be $160,000.

SPECIAL VALUATION RULE FOR CERTAIN EQUITY-BASED AWARDS
The Section 280G rules provide a taxpayer-friendly methodology for calculating the Section 280G “value” of the vesting acceleration associated with equity awards that contain time-based vesting schedules. If the special valuation applies, the Section 280G value of the vesting acceleration can be significantly less than the "spread" (i.e., the difference between the fair market value of the stock underlying the award and any exercise or base price for the award). On the other hand, unvested equity awards that contain a performance-based vesting schedule generally are not eligible for the special valuation rule, and the entire value of such awards is included under the Section 280G rules.

PRIVATE COMPANIES CAN “CLEANSE” PARACHUTE PAYMENTS WITH SHAREHOLDER APPROVAL
One of the most common exceptions under Section 280G applies to privately held corporations. Section 280G generally provides that if holders of stock possessing more than 75% of the voting power of all outstanding stock of a privately held target corporation immediately prior to the potential acquisition approve the payments and benefits submitted for shareholder approval and, before the vote, there is adequate disclosure to all of the target corporation’s shareholders of record of the material facts concerning such payments and benefits, the adverse tax consequences to the employer and disqualified individuals described above should not apply.

In general, the process for obtaining Section 280G shareholder approval involves a number of steps.

Disqualified Individuals Must Execute Advance Parachute Payment Waiver Agreements. The Section 280G rules provide that the vote of target shareholders must determine a disqualified individual’s right to receive or retain potential parachute payments. As a result, the disqualified individual is asked to execute a parachute payment waiver agreement before any shareholder approval documents are distributed to target shareholders. A parachute payment waiver agreement generally provides that the disqualified individual agrees to waive the aggregate amount of the individual’s compensatory payments that equals or exceeds three times the individual’s base amount if the requisite shareholder approval is not obtained. In other words, if the requisite shareholder approval is not obtained, the disqualified individual essentially would forfeit the aggregate amount of compensatory payments that exceeds one dollar less than three times the individual’s base amount.

Must Solicit All Target Shareholders for 280G Shareholder Approval. After the parachute payment waiver agreement has been executed, both a Section 280G information statement and a shareholder consent are circulated to all target shareholders of record on the record date, not just those target shareholders whose vote is needed to satisfy the requisite voting threshold. The Section 280G information statement must contain a detailed disclosure of the material facts concerning all potential parachute payments. For example, with respect to acquisition bonus payments, the following facts must be disclosed: the event or events triggering the payment, the maximum dollar amount that could be paid to the disqualified individual, the payment timing, and any other material terms and conditions associated with receiving the payment.
There are a number of specific requirements to keep in mind with respect to the Section 280G shareholder approval process:

- **Must Offer Separate Voting on Acquisition and Parachute Payments.** The Section 280G rules provide that approval of the acquisition cannot be contingent or otherwise conditioned on approval of payments subjected to the Section 280G shareholder approval process. In other words, the target corporation must allow shareholders to vote “Yes” to the acquisition and “No” to payments subjected to the Section 280G shareholder approval process.

- **No Advance Voting Agreements.** In light of the requirement that a disqualified individual must execute a parachute payment waiver agreement and agree to put the requisite portion of the individual’s compensatory payments at risk, target shareholders cannot agree in advance to approve any payments subjected to the Section 280G shareholder approval process.

- **Aggregate Approval of Parachute Payments Permitted.** The vote can be a single vote on all payments to all disqualified individuals.

**REASONABLE COMPENSATION EXCEPTION MAY BE HELPFUL FOR PUBLIC COMPANIES**

The term “parachute payment” does not include any compensatory payment (or any portion of a payment) that constitutes reasonable compensation for personal services actually rendered on or after the date of an acquisition. For purposes of this rule, a covenant not to compete generally is treated as an agreement for the performance of personal services to the extent that it is demonstrated by clear and convincing evidence that the agreement substantially constrains the individual’s ability to perform services and there is a reasonable likelihood that the agreement will be enforced against the individual.

Because publicly held corporations cannot cleanse potential parachute payments through the shareholder approval exception described above, it is common for publicly held target corporations and their executives to analyze whether all or a portion of any payments conditioned on compliance with a post-closing noncompetition agreement could be treated as reasonable compensation. As a practical matter, this strategy is fact-intensive and requires both an analysis of whether the noncompetition arrangement is enforceable under applicable state laws and an outside third-party valuation of the Section 280G value of the noncompetition arrangement based on the specific facts and circumstances.

**DUE DILIGENCE ISSUES**

Due to the technical complexities under the Section 280G rules, target corporations should generally engage outside tax counsel early in the due diligence process to identify any potential Section 280G issues and analyze whether any exceptions could be available. During the due diligence process, target corporations are typically asked to provide a detailed analysis (including calculations) and documentation related to potential parachute payments.

**CUSTOMARY PROVISIONS IN DEFINITIVE ACQUISITION AGREEMENTS**

Companies customarily include provisions such as the following in definitive acquisition agreements to address Section 280G matters:

- **In M&A transactions involving either publicly or privately held target corporations:** Representations and warranties that there are no payments or benefits that could constitute a “parachute payment” under Section 280G and no related tax gross-up or other reimbursement arrangements that could be triggered as a result of the consummation of the transaction.
In M&A transactions involving privately held target corporations: A covenant that the target corporation will take the necessary actions to cleanse any potential parachute payments through the shareholder approval process under the Section 280G rules and a closing condition that the target corporation will deliver satisfactory evidence that either the requisite shareholder approval under Section 280G was obtained or the requisite shareholder approval was not obtained and, as a consequence, the potential parachute payments will not be made, retained, or provided, pursuant to a parachute payment waiver agreement entered into by the affected individuals.

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