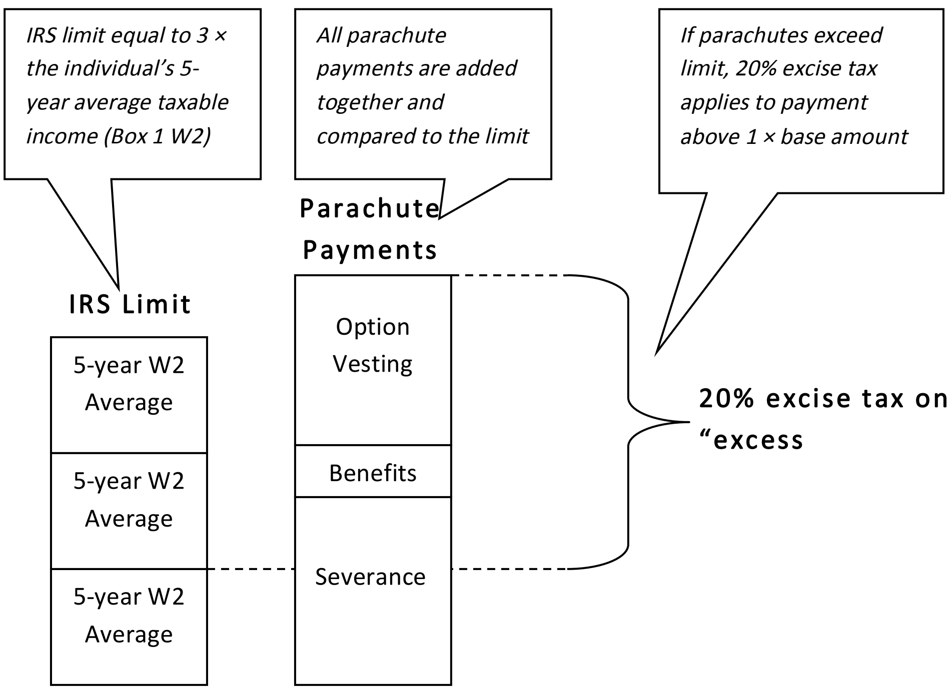
Section 280G—Golden Parachutes

The Basics

Many companies promise contractually to make special payments or provide special benefits to executives at the time of, or upon a qualified termination of employment following, a merger, acquisition or other change in control (CIC) of the company. These payments, such as severance pay, benefits continuation or acceleration of vesting on stock incentives are commonly referred to as golden parachutes. (Further information on golden parachute design can be found under “CIC Severance Arrangements”.)

These payments may trigger special excise tax liabilities under Internal Revenue Code Section 280G (280G) if they exceed certain limits. Section 280G classifies payments which are “*contingent*” upon a change in control of the company as “*parachute payments*”. If the aggregate parachute payments paid to any “*disqualified individual*” exceed three times that individual’s five-year average taxable income (*base amount*), then a 20% excise tax is applied to all parachute payments in excess of one times the individual’s base amount. The illustration below outlines the basics of 280G.



A CIC is generally defined as a merger in which a majority of the company’s shareholders change, a change in the majority of the board of directors or a sale of a substantial portion of the company’s assets.

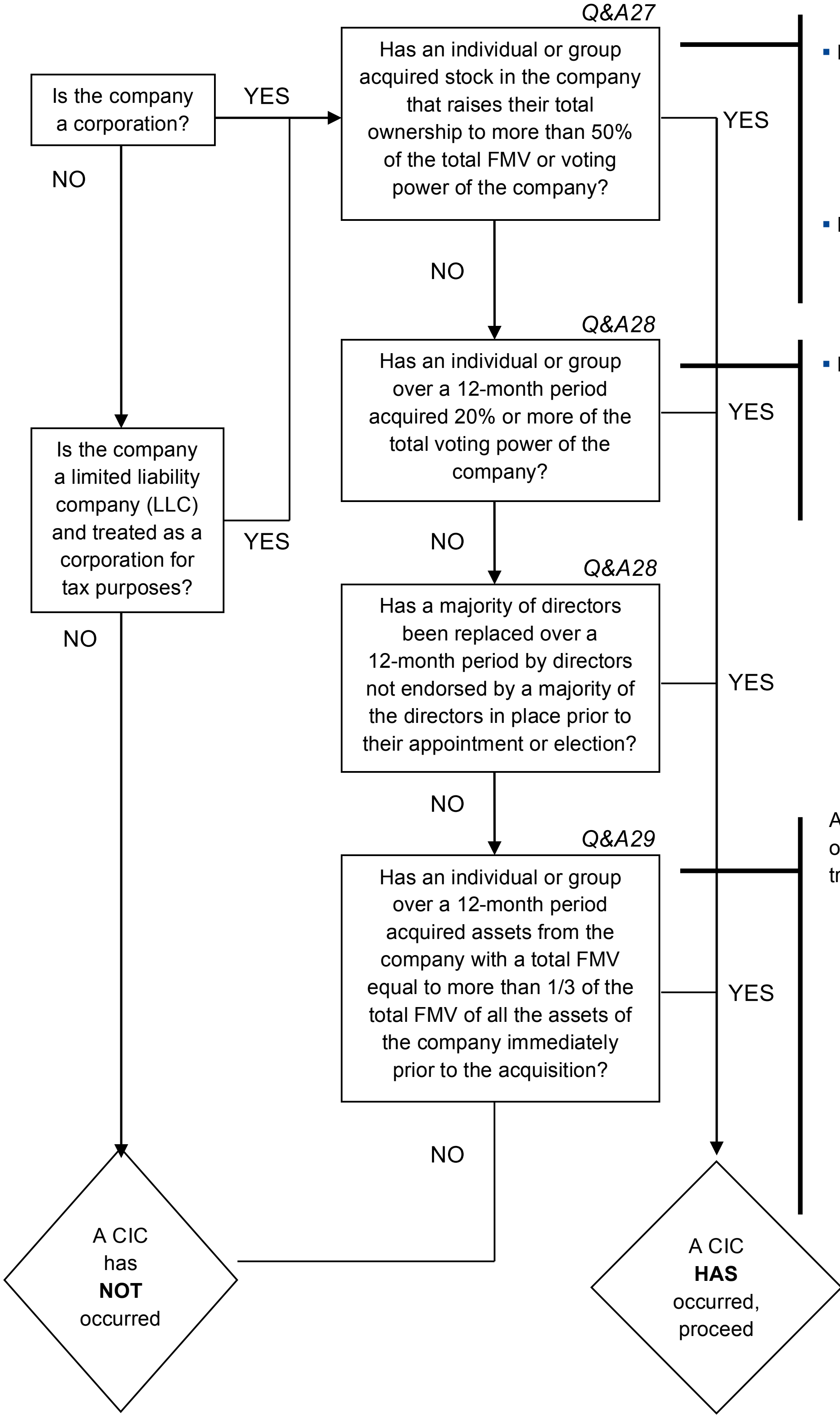
Key Questions in Determining 280G Liability

In determining an excise tax liability, the following key questions must be considered:

1. Has a change in control occurred?
2. Who are the disqualified individuals?
3. What are the aggregate parachute payments for each individual?
4. What is each individual’s base amount and parachute limit?
5. How much, if any, excise tax is due?

The Details—Section 280G

Has a change in control occurred?



- If a person or group already owns more than 50% of the total FMV or voting power of the company, the acquisition of additional shares will **not** be deemed a change in ownership.
- Individuals are not "acting as a group" simply because they purchase shares at the same time.

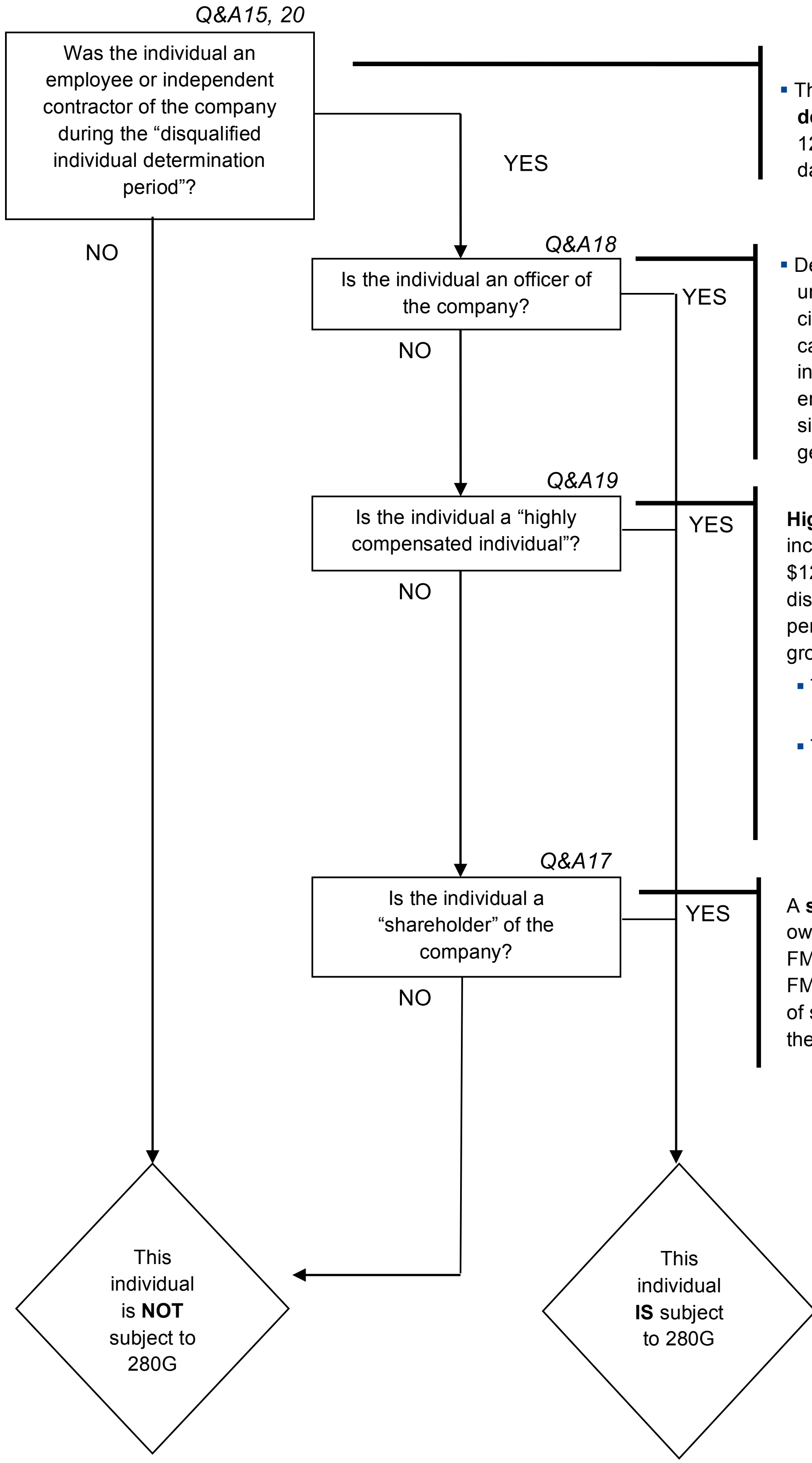
- If a person or group is considered to effectively control a company, the acquisition of additional control will **not** be deemed a change in control.

A change in ownership has not occurred if such transfer of assets is transferred to:

- A shareholder of the company in exchange for its stock.
- An entity in which the company owns 50% or more of its stock.
- A person or group owning 50% or more of the total value or voting power of the company.
- An entity in which a person as described in bullet three above owns 50% or more of the total value or voting power.

Note: 280G Q&A's shown in *italics.*

Who are the disqualified individuals?



- The **disqualified individual determination period** is the 12-month period prior to the CIC date.

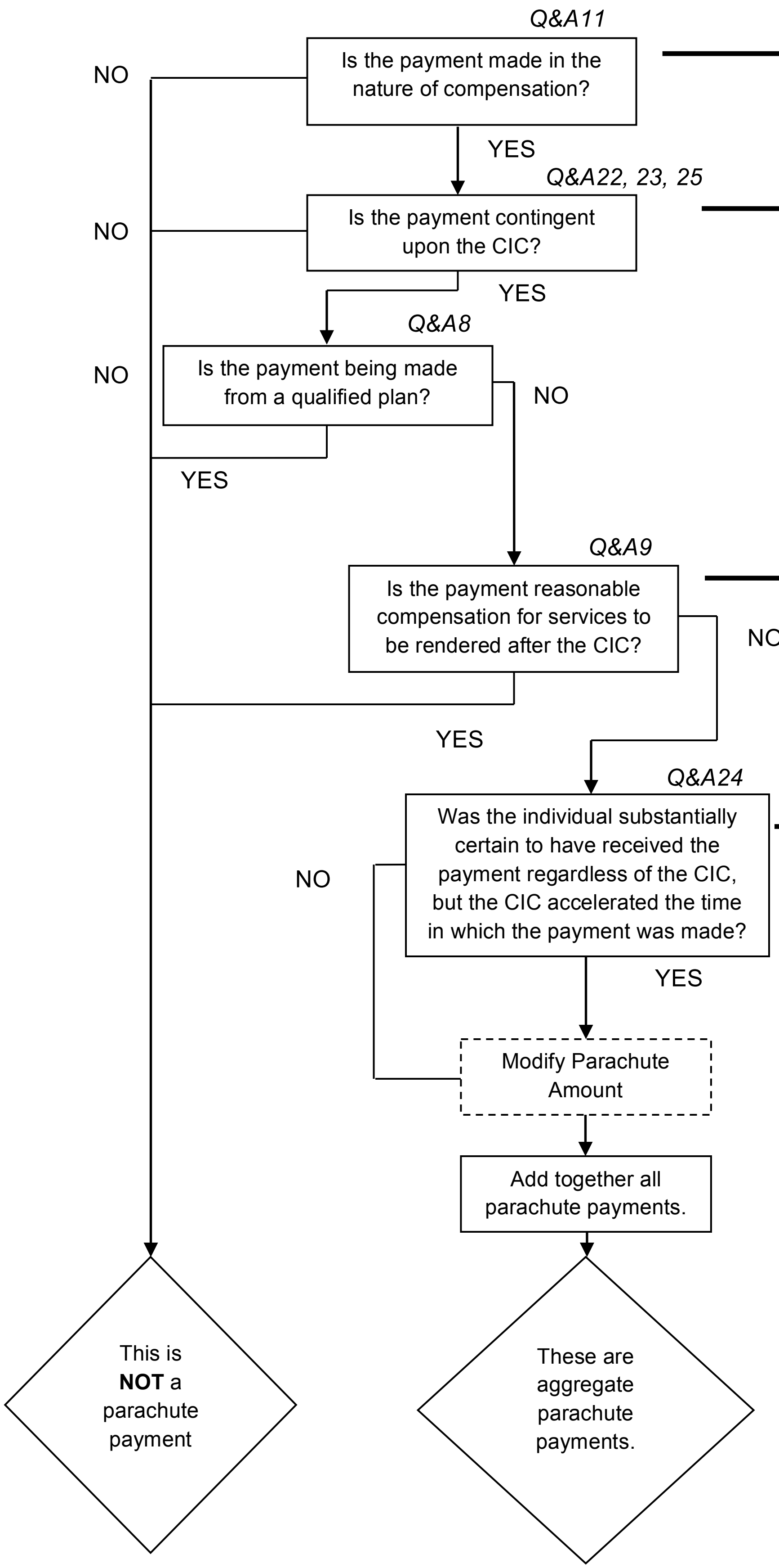
- Determination of an officer is unique to the facts and circumstances of the particular case with emphasis on the individual's authority. Individuals employed for only a special or single transaction are not generally officers.

Highly compensated individuals include individuals earning more than $120,000 (for 2015) in the disqualified individual determination period who fall into the following group. The lesser of:

- The highest paid 1% of employees at the company; or
- The highest paid 250 employees ranked by compensation paid during the disqualified individual determination period.

A **shareholder** is any individual who owns stock of the company with an FMV that exceeds 1% of the total FMV of the company. The definition of stock includes outright shares and the face value of stock options.

What are the aggregate parachute payments for each individual?



- Generally, all payments that arise out of an employment relationship or are for services rendered are in the nature of compensation.

- A payment is generally contingent upon a CIC if it would not have been made had no CIC occurred or if the CIC accelerated the time at which the payment was made.
- Payments made pursuant to an agreement entered into after the CIC are not contingent.
- Payments made pursuant to an agreement entered into within one year before the CIC are presumed contingent.

- Generally, any payments which the taxpayer establishes with clear and convincing evidence as reasonable compensation for service to be rendered on or after the CIC are exempt from the definition of parachute payments.

- Only a portion of payments that become vested due to a CIC are deemed parachute payments, i.e., vesting of stock options.
- A portion of the payment is deemed a parachute due to the benefit of receiving the payment early.
- Another portion of the payment is deemed a parachute due to the benefit of not performing service to receive the payment.

What is each individual's base amount and parachute limit?

Q&A35

Determine Base Period

- The **base period** is the most recent 5 taxable years ending before the CIC in which the individual was an employee or independent contractor of the company.
- If the individual was not an employee or independent contractor for the entire 5-year period, the base period is the portion of the period during which they performed services for the company.

Q&A34, 36

Calculate Base Amount

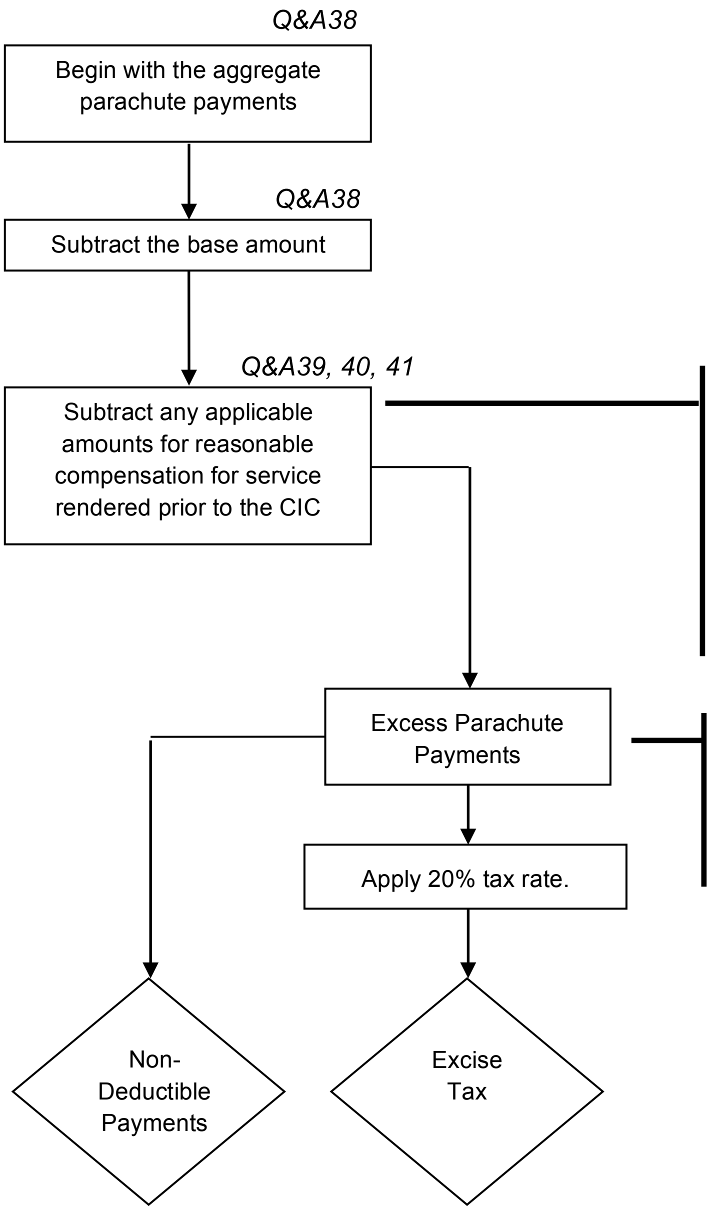
- The **base amount** is the average annual compensation which was included in gross income for the individual during the base period (Box 1 on the W2).
- Any partial years should be annualized before calculating the average, taking into account the frequency of the payment. Any one-time payments, such as bonuses, should not be annualized.
- If the individual was not an employee prior to the year of the CIC, the base amount is the annualized taxable compensation paid prior to the CIC that was not contingent upon the CIC.

Q&A30

Calculate Parachute Limit

- The parachute limit is equal to 3× the individual's base amount.

How much, if any, excise tax is due?



- Excess parachute payments can be reduced by any portion of the payment the taxpayer establishes as reasonable compensation for services rendered prior to the CIC.
- The base amount must first be allocated to the payment. The reasonable portion is then reduced by the allocated portion of the base amount. Any remaining reasonable compensation is then subtracted from the excess parachute.

- The excess parachute payment is subject to a 20% excise tax.
- The excess parachute is also a **non-deductible payment** for the company.