¶ 5720. GOLDEN PARACHUTES

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OVERVIEW

An employer is not entitled to a deduction for "excess parachute payments," and the employee receiving such payments is liable for a 20% nondeductible excise tax. Excess parachute payments are "parachute payments" in excess of an exempt "base amount." Parachute payments include any payment of cash or property in the nature of compensation which is made or is to be made to or for the benefit of any corporate officer or shareholder or highly compensated individual (*i.e.*, a "disqualified individual") who performs or has performed services for such corporation, provided that: (1) such payment is contingent upon a change in the ownership or effective control of the corporation or in the ownership of a substantial portion of the assets of the corporation, and (2) the aggregate present value of such payments to or for the benefit of such disqualified individual equals or exceeds an amount equal to three times the individual's base amount ("mathematical test parachute payments"). Parachute payments also include payments in the nature of compensation to or for the benefit of a disqualified individual in connection with a potential or actual change in ownership or control pursuant to an agreement that violates any generally enforced federal or state securities laws or regulations ("securities violation parachute payments"). Payments may unintentionally trigger the penalties of the golden parachute provisions to the extent they are counted in determining if the applicable three times base amount threshold is exceeded, even though the same type of payments may or may not be counted in determining the applicable base amount.

A parachute payment does not include any payment relating to an S corporation, or any payment by any other corporation ("C corporations") whose stock is not readily traded on an established securities market, if the payment has been approved by shareholders. For C corporations, such approval must be obtained by more than 75% of the voting power of all outstanding stock (determined immediately before the change of control) and must have been based upon adequate disclosure to such shareholders of all material facts concerning potential parachute payments. Parachute payments do not include any payment to or from a qualified plan, and distributions from a tax-qualified plan will not be affected by the golden parachute provisions even if they are increased in the event of a change in control (*e.g.*, by utilizing pension assets in excess of some percentage of full funding liabilities to provide an additional benefit to all pension plan participants). Reasonable compensation for personal services to be rendered after the date of a change of control is also excluded from the status of parachute payments. However, reasonable compensation for services rendered before the change of control is not completely excluded from parachute payment status, and can, in non-abusive situations, trigger the golden parachute penalty provisions and sometimes produce harsh results.

CHAPTER OUTLINE

1044-7261/90/$0+.50

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EXPLANATION

¶ 5720.01
Payment in the Nature of Compensation

To fit within either the "mathematical test" or "securities violation" definition of a parachute payment, the payment must be "in the nature of compensation." All payments — in whatever form — are payments in the nature of compensation if they arise out of an employment relationship or are associated with the performance of services, *e.g.*, holding oneself out as available to perform services and refraining from performing services (such as under a covenant not to compete or similar arrangement). [1] Parachute payments may be paid directly or indirectly by the corporation that undergoes a change of control, by a person acquiring ownership or effective control of that corporation or ownership of a substantial portion of that corporation's assets, or by any person whose relationship to such corporation or other person is such as to require attribution of stock ownership between the parties. [2]

▶ **Example**—*Payment as Compensation*

X is a less than majority shareholder of Company A who effectively controls Company A. Contingent upon the successful acquisition of Company B pursuant to a tender offer by Company A, X agrees to pay $200,000 to Y, who is an officer of Company B. Although X is not specifically described above, the payment could be treated as a capital contribution to Company A by X followed by a payment by Company A to Y. As a result, the payment could be treated as a parachute payment.

Payments in the nature of compensation include (but are not limited to) wages and salary, bonuses, severance pay, fringe benefits, pension benefits and other deferred compensation (including any amount characterized by the parties as interest thereon). However, consistent with the existing case law, payments in the nature of compensation do not include attorney's fees or court costs paid or incurred in connection with the payment of any amount which constitutes a parachute payment. [3]

Note: Existing agreements or arrangements which provide benefits the amount of which could be disputed following a change of control should be amended to also provide that the company will pay any attorney's fees or court costs which the executive-beneficiaries of such agreements incur in connection with the enforcement of the acquiring successor corporation's obligation to pay any benefits thereunder.

Transfers of property are treated as payments in the nature of compensation. [4] The amount of any payment in the nature of compensation is reduced by the amount of any money or the fair market value (determined as of the date the property is transferred by the disqualified individual) of any property owned by the disqualified

[1] Prop. Regs. §1.280G-1, Q&A-11(a); *cf.* §162(a) and the regulations thereunder. Note that the §280G golden parachute regulations are merely proposed regulations and were not also issued as temporary regulations. Furthermore, there are no comments in the Preamble to these proposed regulations regarding the reliance which a taxpayer can place on them. However, proposed regulations now constitute substantial authority for purposes of the substantial understatement of tax penalty under §6661 and Regs. §1.6661-3(b)(2) pursuant to H.R. Rep. No. 101-386, p. 653, Conference Report to the Omnibus Reconciliation Act of 1989. Nevertheless, caution should be exercised when following the proposed regulations with respect to an issue where the regulations are inconsistent with the legislative history.

[2] Prop. Regs. §1.280G-1, Q&A-10; §318(a).

[3] Prop. Regs. §1.280G-1, Q&A-11(a); *Sullivan v. Easco Corp.*, 662 F. Supp. 1396 (D. Md. 1987).

[4] Prop. Regs. §1.280G-1, Q&A-11(b). For a more detailed discussion of this point, *see* ¶ 5720.03.E. *infra.*

individual without restriction that is or will be transferred by the disqualified individual in exchange for such payment. [5]

¶ 5720.02
Payments Made to Disqualified Individuals

Disqualified individuals to whom the golden parachute provisions apply include employees, independent contractors, or other persons who perform personal services for the company *and* who are officers, shareholders or highly compensated individuals at any time during the "disqualified individual determination period" ("determination period"). [6] There is an exception for individuals who own *de minimis* amounts of stock and are not officers or highly compensated. [7]

The term "highly compensated individual" means individuals who are (or would be if they were employees) members of the group consisting of the highest paid 1% of employees of the corporation [8] or, if less, the highest paid 250 employees of the corporation when ranked on the basis of compensation paid during the determination period. [9] For this purpose, all employers who are members of the same affiliated group are treated as a single corporation. Thus, any highly compensated employee of one member of the group is a highly compensated employee of the entire group. [10] However, no individual whose annualized compensation during the determination period is less than $75,000 [11] is treated as a highly compensated individual. [12] An exception to the definition of "highly compensated individual" prevents fees earned by independent service providers (such as independent brokers, attorneys or investment bankers) from becoming subject to the golden parachute provisions when such service providers perform services in connection with a change in ownership or control, provided that the services are performed in the ordinary course of the individual's trade or business and the individual performs similar services for a significant number of clients unrelated to the corporation. [13]

The term "officer" is limited to no more than the lesser of: (a) 50 employees; or (2) the greater of three employees or 10% of employees. [14] Where the number of officers exceeds the number of the employees who may be treated as officers, then the highest paid of such officers during the determination period are treated as officers for golden parachute purposes. [15] In the case of an affiliated group treated as one corporation, however, the limit on the maximum number of officers is applied not to the affiliated group as a whole but separately to each member of the affiliated group.

Note: Where a company has many subsidiaries, this rule could cause the number of "officer disqualified individuals" to exceed the number of "highly compensated disqualified individuals." For example, under this rule, as many as 50 officers per subsidiary could be considered disqualified individuals, whereas the maximum highly compensated employees who can be considered disqualified individuals is only 250. Also, this rule appears to be more than is necessary to achieve the objectives of the golden parachute provisions. Even in a large conglomerate there are no more than 50 officers who would be in a position to provide significant termination benefits for themselves. Moreover, the treatment of each affiliated group member as a separate corporation for purposes of the "officer disqualified individual" determination also allows for manipulation. For example, if a conglomerate consists of an affiliated group of 10 separate corporations which has a total of 50 officers and 250 "highly compensated disqualified individuals" (only 30 of which are officers), if the 50 officers of such affiliated group are employees of a member of the affiliated group having only 300 total employees, then only 30 of the officers would be officers for purposes of the golden parachute provisions (which should be the same 30 who are also disqualified individuals because they are highly compensated employees). Accordingly, this rule, although unfavorable to taxpayers in general, may encourage companies to rearrange their officers among members of the affiliated group to avoid its adverse impact.

This determination of the limit on the number of officers is based on the greatest number of employees of the corporation at any time during the determination

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[5] Prop. Regs. §1.280G-1, Q&A-14.

[6] Prop. Regs. §1.280G-1, Q&A-15.

[7] Prop. Regs. §1.280G-1, Q&A-17. For this purpose, an individual who owns stock of a corporation not exceeding the lesser of $1,000,000 or 1% of the total fair market value of the outstanding value of all shares of all classes of the corporation's stock is treated as owning a *de minimis* amount of stock. This determination is made using the constructive ownership rules of §318(a). It is not clear whether this $1,000,000 fair market value limitation must be satisfied each day of the determination period. If so, significant administrative complexity is added with respect to shareholders who are close to this $1,000,000 threshold.

[8] Rounded up to the nearest integer.

[9] §280G(c); Prop. Regs. §1.280G-1, Q&A-19. *See* Prop. Regs. §1.280G-1, Q&A-21, for the definition of compensation for this purpose.

[10] §280G(d)(5). Such determination is made under §1504 (without regard to §1504(b), which would otherwise exclude certain corporations from consideration). *See* Prop. Regs. §1.280G-1, Q&A-46.

[11] The proposed regulations do not indicate whether this $75,000 amount will be indexed to increase similar to the $75,000 amount contained in the definition of highly compensated employees for purposes of qualified plans. *See* §414(q).

[12] Prop. Regs. §1.280G-1, Q&A-19(a).

[13] Prop. Regs. §1.280G-1, Q&A-19(b). It is not clear why the proposed regulations require that such independent service providers provide change of control type services for a significant number of clients. This requirement seems to be more restrictive than is necessary to achieve the objectives of the golden parachute provisions.

[14] Rounded up to the nearest integer.

[15] Prop. Regs. §1.280G-1, Q&A-18(c).

1044-7261/90/$0+.50

period. [16] However, a similar rules does not appear regarding the number of employees for purposes of determining the maximum number of "highly compensated disqualified individuals" based on the 1% test. [17] Furthermore, although certain employees are excluded from the total number of employees when limiting the maximum number of "highly compensated disqualified individuals" based on the 1% test, [18] those same exclusions do not appear to apply for purposes of determining the maximum number of "officer disqualified individuals." [19]

Whether an individual is an officer with respect to a corporation is determined on a facts and circumstances basis. Relevant factors include the source of the individual's authority and the nature and extent of the individual's duties. [20] Generally, the term "officer" is intended to refer to an administrative executive in regular and continued service, and not those employed for a single special transaction. [21] The golden parachute rules specifically provide that an individual's status as an officer will be determined on the basis of the functions of his position, not on the basis of his title. [22]

Note: Despite the limitations described above, the group of "disqualified individuals" potentially affected by the golden parachute provisions still seems much larger than the group which was the original focus of concern (*e.g.*, the group effectively controlling the corporation). The broad definition of officers, as well as the large number of "highly compensated disqualified individuals," seems misplaced compared to the abuses which the golden parachute provisions were designed to prevent. Many of the individuals who will be considered disqualified individuals have no power to provide excessive benefits to themselves upon a termination of employment.

Although there is no statutory language regarding the time when the status of a person as a disqualified individual is determined, the proposed regulations focus on the determination period, which is the portion of the year of the corporation ending on the date of the change of control plus the immediately preceding 12-month period. [23] Some planning is possible for fiscal year corporations, since a fiscal year corporation may elect to base such determination on either its taxable year or the calendar year. [24]

▶ **Example**—*Disqualified Individual Determination Period*

If a corporation with a May 31 taxable fiscal year-end incurred a change of ownership on June 12, 1988, its determination period can be either the period which began June 1, 1987 and ended June 12, 1988, or the period which began Jan. 1, 1987 and ended June 12, 1988. A corporation with a Dec. 31 taxable year-end would, however, be limited to only the longer of such 2 determination periods.

For purposes of determining the disqualified individuals of a corporation, the term "compensation" includes compensation which was payable by the corporation with respect to which the change in control occurs, compensation paid by a predecessor entity, [25] or compensation paid by a related entity. [26] Compensation includes elective or salary reduction contributions to a cafeteria plan, a cash or deferred arrangement or a tax-sheltered annuity. [27] When determining who are the officer and highly compensated disqualified individuals, however, any compensation that was contingent on the change in control and that was payable in the "year of the change" [28] is ignored. [29]

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[16] *Id.*

[17] *See* Prop. Regs. §1.280G-1, Q&A-19.

[18] Prop. Regs. §1.280G-1, Q&A-19(c) excludes employees who normally work less than 17-1/2 hours per week, or normally work not more than 6 months during any year. *See also* §414(q)(8)(B) and (C). Even if employees are not counted in determining total employees, those same employees can, however, be highly compensated individuals with respect to the corporation.

[19] *See* Prop. Regs. §1.280G-1 Q&A-18(c)

[20] Prop. Regs. §1.280G-1, Q&A-18(a).

[21] *Id. Cf.* Regs. §1.416-1, T-13.

[22] Prop. Regs. §1.280G-1, Q&A-18(a).

[23] Prop. Regs. §1.280G-1, Q&A-20, Q&A-19(a) & Q&A-15. It is not clear why the proposed regulations utilize a determination period for disqualified individual status of more than 12 months. By so doing, the compensation of an employee could include 2 of the same type of payment (*e.g.*, 2 bonuses) when determining who are "highly compensated disqualified individuals." It would appear that the determination period should be reduced to a period of only 12 months, or alternatively, the compensation for "highly compensated disqualified individual" determination purposes should be limited to compensation attributable to services rendered during the determination period.

[24] In the case of an affiliated group treated as 1 corporation, the taxable year of the common parent controls. *See* Prop. Regs. §1.280G-1, Q&A-20(a).

[25] An entity which, as a result of a merger, consolidation, purchase or acquisition of property or stock, corporate separation, or other similar business transaction, transfers some or all of its employees to the corporation undergoing the "change of control," or a related entity or predecessor entity of such corporation. *See* Prop. Regs. §1.280G-1, Q&A-21(b).

[26] All members of an affiliated group of corporations as defined in §§414(b), 414(c), 414(m), 414(o) and 414(n). *See* Prop. Regs. §1.280G-1, Q&A-21(b).

[27] Prop. Regs. §1.280G-1, Q&A-21(a). The proposed regulations use the phrase "compensation which was payable." As a result, it is not clear whether this includes the values of vested but unexercised stock options and stock appreciation rights (SARs), deferred compensation, restricted property where the restrictions have lapsed, and income from the exercise of stock options and SARs. The specific reference to certain types of deferred compensation, however, suggests that any other non-taxable deferred compensation would not be included within this definition of compensation.

[28] It is not clear whether this refers to the corporation's taxable year or the calendar year. *See* Prop. Regs. §1.280G-1, Q&A-21(c).

[29] Note that there is no similar exclusion for compensation that is contingent on a change in control when determining the disqualified individual's base amount. For a more detailed discussion of why a similar exclusion is unnecessary in that context, *see* ¶ 5720.03.D, *infra.*

Personal service corporations and similar entities are treated as individuals for purposes of the determination of disqualified individuals. [30] Thus, if an individual performs services for a corporation as a professional corporation, and if the compensation paid by another corporation to such personal service corporation is sufficient to make the payee corporation a "highly compensated individual of the payor corporation," the personal service corporation would be treated as a disqualified individual with respect to the payor corporation, and any excess parachute payments to the personal service corporation would be subjected to the adverse tax consequences of the golden parachute provisions. [31] Similarly, any corporate office held by the individual performing services for the personal service corporation would presumably be treated as being held by his personal service corporation, potentially making the personal service corporation an officer disqualified individual. [32] In such a case, the parachute payments made to the personal service corporation are treated as made to a disqualified individual, and the personal service corporation would therefore owe the excise tax if the payments made to such personal service corporation exceed the three-times-base-amount threshold. [33] The purpose of these rules is to prevent relatively easy circumvention of the golden parachute provisions by the formation of personal service corporations and similar entities.

¶ 5720.03
Mathematical Test Parachute Payments

¶ 5720.03.A
Payments Made upon a Change of Control

The proposed regulations provide three tests for determining whether or not a change in ownership or control has occurred. Two of the tests — the "stock ownership test" and the "asset ownership test" — are objective tests. The other test (the "effective control test") is subjective and is generally broader than the other two tests. For purposes of the "stock ownership test," a change in the ownership of a corporation occurs on the date that any one person, or more than one person acting as a group, acquires ownership of stock of the corporation that, together with stock held by such person or group, possesses more than 50% of the total fair market value or voting power of all of the corporation's outstanding stock. [34] For this purpose, an increase in the percentage of stock ownership resulting from a transaction in which the corporation acquires its stock in exchange for property is treated as an acquisition of stock. However, if any one person or group owns more than 50% of the total fair market value or total voting power of the stock of a corporation, the acquisition of additional stock by the same person or group is not considered to cause a change in the ownership of the corporation (or to cause a change in the effective control of the corporation). [35]

For purposes of the "asset ownership test," a change in the ownership of a substantial portion of the assets of a corporation occurs on the date that any one person or group acquires (or has acquired during the 12 months ending on the date of the most recent acquisition by such person or persons) assets from the corporation worth at least one-third the total fair market value of all of the corporation's assets immediately prior to such acquisition or acquisitions. [36]

Note: This definition would literally include the sale of a segment of a business which constitutes a large percentage of total gross assets of a corporation but very little of the corporation's net asset value. Although, this "one-third" test is intended to be applied on a net asset value basis, the regulations allow the IRS some discretion to utilize a "gross asset value" test in what the Service perceives as abusive situations. This "asset ownership test" potentially creates tax planning opportunities. For example, if the test is ultimately applied on a "gross asset" basis, the percentage of total assets which are acquired may be reduced prior to the acquisition by either retaining non-operating assets which would normally be sold, borrowing funds and retaining the borrowed funds as cash or other liquid investments, or acquiring other non-operating assets immediately prior to the acquisition. Of course, if the "asset ownership test" is applied on a "net asset" basis, these opportunities would be unavailable to the extent the additional assets are acquired with borrowed funds. Also, it may be possible to acquire more than one-third of a company's assets by purchasing some of the stock of the company (avoiding a change in stock ownership type of change of control or an effective change of control), and receiving the desired assets in redemption of such stock. Of course, all of these methods could be attacked by the IRS using other doctrines, but the planning possibilities do exist for non-abusive situations. Note that it is also not clear whether this one-third test will be applied using book value or market value of assets.

The proposed regulations limit the impact of the change in asset ownership type of change of control by providing that certain related party transfers of assets by

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[30] Prop. Regs. §1.280G-1, Q&A-16.

[31] *Id.* H. Conf. Rep. No. 861, 98th Cong., 2d Sess. 850 (1984).

[32] Note, however, that this language from the legislative history does not appear in the proposed regulations. *See* H. Conf. Rep. No. 861, 98th Cong., 2d Sess. II-850 (1984).

[33] §280G(c), Staff of the Joint Committee on Taxation, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (Joint Committee Print 1984) at 201 ("DEFRA Blue Book").

[34] Prop. Regs. §1.280G-1, Q&A-27(a), (c) and (d), Example (1). Section 318(a) applies in determining stock ownership for this purpose.

[35] Prop. Regs. §1.280G-1, Q&A-27(a) and (d), Example (4).

[36] Prop. Regs. §1.280G-1, Q&A-29(a) and (d), Examples (1) and (2).

1044-7261/90/$0+.50

a corporation will not be treated as a change in ownership. These include transfers to:

- shareholders of the corporation in exchange for or with respect to their stock;
- tiered entities, where the parent controls 50% or more of the subsidiary's stock; or
- a person (or group of persons) who owns 50% of the stock of such transferring corporation or to an entity also controlled (50% ownership) by such person or group. [37]

A change in the effective control of a corporation is presumed to occur on the date when either: (a) any person or group acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition) ownership of at least 20% of the corporation's total voting stock, or (b) a majority of the corporation's board of directors is replaced during any 12-month period by directors whose appointment or election is not endorsed by a majority of the members of the corporation's prior board of directors. In the absence of the two events described above, the presumption is that no change in effective control occurred. [38] This presumption may, however, be rebutted by establishing that such acquisition or acquisitions of the corporation's stock, or such replacement of the majority of the members of the corporation's board of directors, does not transfer the power to control (directly or indirectly) the management and policies of the corporation from any one person or group to another person or group. [39] Furthermore, if any one person or group is considered to "effectively control" a corporation as described above, the acquisition of additional control of the corporation by the same person or group is not considered to cause a change in the effective control of the corporation (or to cause a change in the ownership of the corporation). [40]

In determining whether a change in ownership or control has occurred under the tests outlined above, two important rules apply. First, persons will not be considered to be "acting as a group" merely because they happen to purchase or own stock of the same corporation at the same time, or as a result of the same public offering. Persons will, however, be considered to be "acting as a group" if they are owners of an entity that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. [41] Second, all members of an affiliated group are generally treated as one corporation. [42]

¶ 5720.03.B
Payment Must Be Contingent on the Change of Control

To be classified as a parachute payment under the mathematical test, a payment must also be "contingent on" the change in effective control or change in ownership of stock or assets of a corporation (hereinafter collectively referred to as "change in control" or "change of control"). A payment can be treated as contingent on a change in ownership or control even if the employment or independent contractor relationship of the disqualified individual is not terminated (voluntarily or involuntarily) as a result of the change. [43] There is no statutory definition of the phrase "contingent on change of control," although legislative history indicates that the concept is very broad and uncertain [44] and suggests that payments which are only nominally related to a change of control can be treated as contingent on such change of control.

The proposed regulations, however, provide a more limited rule by indicating that a payment will not be treated as contingent on a change unless it is either "expressly contingent" on such change or "implicitly contingent" on such change. The "expressly contingent test" is a "but for" test, *i.e.*, it asks whether payment would not have been made but for the change of control. A payment generally will be treated as contingent under this rule unless it is substantially certain, at the time of the change, that the payment would have been made whether or not the change occurred. [45] Property that becomes substantially vested as a result of a change in ownership or control will not be treated as a payment that was substantially certain to have been made whether or not the change occurred. [46]

The "implicitly contingent test" provides that payment generally is treated as contingent on a change of control if the following three conditions are met:

- the payment is contingent on an event that is "closely associated" with such a change,
- a change in ownership or control actually occurs, and
- the event is "materially related" to the change in ownership or control. [47]

The same "but for" test adopted for the "expressly contingent test" applies in determining whether a payment is "contingent on an event" (*i.e.*, in order to not be

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[37] Prop. Regs. §1.280G-1, Q&A-29(b), (c) and (d), Example (3). For this purpose, stock ownership is determined using §318(a).

[38] Prop. Regs. §1.280G-1, Q&A-28(a).

[39] *Id.* For this purpose, §318(a) applies in determining stock ownership.

[40] Prop. Regs. §1.280G-1, Q&A-28(b).

[41] Prop. Regs. §1.280G-1, Q&A-27(b) and 28(c).

[42] Prop. Regs. §1.280G-1, Q&A-46. For this purpose, members of an affiliated group are determined based on §1504(a), but without regard to the exceptions in §1504(b).

[43] Prop. Regs. §1.280G-1, Q&A-22(d).

[44] *See* DEFRA Blue Book, p. 201; H.R. Rep. No. 861, 98th Cong., 2d Sess. 851 (1984); S. Rep. No. 313, 99th Cong., 2d Sess. 915 (1986).

[45] Prop. Regs. §1.280G-1, Q&A-22(a).

[46] *See* Regs. §1.83-3(b).

[47] Prop. Regs. §1.280G-1, Q&A-22(b).

so contingent, it must be substantially certain at the time of the event, that the payment would have been made whether or not the event occurred).

Some types of events that are considered "closely associated" with a change in ownership or control under this three prong "implicitly contingent test" are the onset of a tender offer, the termination (voluntary or involuntary) of the disqualified individual's employment, [48] a significant reduction in the disqualified individual's job responsibilities, a substantial increase in the market price of the corporation's stock that occurs within a short period (but only if such increase occurs prior to a change in control), the cessation of the listing of the corporation's stock on an established securities market, and the acquisition of more than 5% of the corporation's stock by a person (or more than one person acting as a group) not already in control of the corporation. [49]

Note: Thus, it is evident that an event is considered "closely associated" with a change in ownership or control if the event is of a type that frequently occurs in connection with a change in control. Whether other events will be treated as closely associated with a change in control will be based on all the facts and circumstances of the particular case. Any attempts to pick as payout triggers events not closely associated with a change in control (but which occur in 99% of the change of control situations) would likely be ineffective in avoiding characterization of payments as parachute payments. Even if the payments would actually be triggered in cases other than a change of control (consider termination of employment, for example), the IRS would likely categorize such payout trigger events as "materially related" where there was an obvious attempt to avoid golden parachute consequences.

An event will be presumed to be "materially related" to a change in control if the event occurs within the period beginning one year before and ending one year after the date of the change in control. Note that unlike the one year presumption with respect to execution of an agreement providing payments, this presumption applies to events which occur both before and after the change of control. If such "materially related" event occurs outside the period beginning one year before and ending one year after the date of change in control, the event will be presumed not to be materially related to the change in control. [50]

Accordingly, if, for example, a severance pay plan provides payment will be made if the employee is terminated for any reason (whether or not the termination of employment occurs in connection with a change of control), and severance occurs two years after the change in control, the presumption is that this would not be a parachute payment. [51] If the executive's termination occurred less than one year after the change of control, however, but as a result of unanticipated losses of the corporation rather than events related to the change, the payment would be presumed to be contingent on the change but should not ultimately be treated as contingent on the change, provided that the executive can show that the termination resulted for unanticipated events that were unrelated to the change so as to rebut the one-year presumption. [52] However, under the proposed regulation's interpretation of the "contingent on the change" requirement, the relevant agreement does not have to state that payment is contingent upon a change of control if payment is caused by the change (*i.e.*, termination of employment following a change of control).

However, if a payment upon a change of control does not increase the present value of the item in question, the payment is not a parachute payment. [53] Accordingly, the payment of benefits pursuant to an individual account plan that provides for the payout of vested benefits upon termination of employment generally does not create adverse parachute payment consequences when termination of employment occurs as a result of a change in control.

A payment is treated as contingent on a change in control if the change accelerates the time at which the payment is made. [54] However, although the full amount of a payment is generally treated as contingent upon a change in ownership or control, a different rules applies if it is substantially certain at the time of the change that the payment would have been made whether or not the change occurred, but the payment is treated as contingent on the change only because the change accelerates the time at which the payment is made. [55] In such cases, the portion of the payment treated as contingent on the change is the amount by which the accelerated payment exceeds the present value of the payment that would

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[48] Note that in order for a payment contingent upon the termination of employment to be covered by this "implicitly contingent test," the termination payments must be pursuant to contracts which provide for such termination payments in other than change in control situations. In other words, a termination agreement which provides for a payment upon termination of employment only in the event of a change of control ("double trigger employment contracts") would be explicitly contingent upon a change and it would not be necessary to apply the "implicitly contingent test."

[49] Prop. Regs. §1.280G-1, Q&A-22(b).

[50] Prop. Regs. §1.280G-1, Q&A-22(b) and (e) (Examples 1 and 2).

[51] Even if the one year presumption applies, however, Prop. Regs. §1.280G-1, Q&A-24 may limit the extent to which the payment is treated as a parachute payment. Note, also, that this 1-year presumption would not apply to payments which are expressly contingent upon a change of control (*e.g.*, "double trigger employment agreements" requiring both termination of employment and a change of control for payment to be made), since those types of payments would be covered by the portion of Prop. Regs. §1.280G-1, Q&A-22(a) which specifically includes as payments contingent on a change of control those payments which are "expressly contingent" on such change.

[52] *See* Prop. Regs. §1.280G-1, Q&A-22(e) (Example 3).

[53] *See* S. Rep. No. 313, 99th Cong., 2d Sess. 916 (1986).

[54] Prop. Regs. §1.280G-1, Q&A-22(c).

[55] Prop. Regs. §1.280G-1, Q&A-24(a) and (b).

1044-7261/90/$0+.50

have been made absent the acceleration.[56] If the amount of such a payment absent the acceleration is not reasonably ascertainable, and if the acceleration of the payment does not significantly increase the present value of the payment absent the acceleration, the present value of the payment absent the acceleration is deemed to be equal to the amount of the accelerated payment.[57] Although the proposed regulations do not elaborate on what constitutes a "significant increase in the present value of the payment absent the acceleration," acceleration of the payment should result in such a significant increase only where the payment was expected to earn a below market rate of return, or was unable to earn a market rate of return, absent the acceleration.[58]

If a payment is accelerated by a change in ownership or control, and it is substantially certain at the time of the change that the payment would have been made without regard to such change had the disqualified individual continued to perform services for the corporation for a specified period of time, only a portion of the payment is treated as contingent on the change.[59] The portion of the payment treated as contingent on the change in such case is the lesser of:

- the amount of the accelerated payment; or
- the amount by which the amount of the accelerated payment exceeds the present value of the payment that was expected to be made absent the acceleration (determined without regard to the risk of forfeiture of such expected payment due to the failure to continue to perform services), plus an amount to reflect the lapse of the obligation to continue to perform services.

If the value of the expected payment is not reasonably ascertainable, the future value of such payment is deemed to be equal to the amount of the accelerated payment.[60]

When vesting is accelerated, the amount reflecting the lapse of the obligation to continue to perform services depends on all of the facts and circumstances. However, in no event will such amount be less than 1% of the amount of the accelerated payment multiplied by the number of full months between: (1) the date that the individual's right to receive the payment is not subject to a substantial risk of forfeiture[61] and (2) the date, absent the acceleration, that the individual's right to receive the payment would not have been subject to a substantial risk of forfeiture.[62]

Note: In situations where there is both accelerated payment and accelerated vesting of benefits, and where the future value of the payment is uncertain, the proposed regulations assume that there will be no future growth in value. This is in contrast to the provision applicable to the accelerated payment of vested amounts (where the unascertainable future value is deemed to be equal to the amount of the accelerated payment). Deferred cash payments will typically be subject to the latter provision, whereas deferred stock and restrictive property payments will often be subject to the former provision. Thus, the result of the difference between these relief provisions is to treat deferred property payments unfairly, compared to deferred cash payments, by assuming an earnings rate for future payments of cash but assuming no earnings rate for future payments of property. It does not seem unreasonable to assume that the stock price of the payor corporation's stock (or any form of future payment) will also increase at a rate equal to the AFR, where both the vesting and payment of such future amount is accelerated, as long as there is no restriction which prohibits such deferred payment from earning a market rate of return.

Note: The proposed regulations also treat plans calling for fixed earnings rates and definite payout dates differently from plans calling for unknown earnings accrual rates or payout dates, where the payout is accelerated by a change in control. No golden parachute consequences would apparently result in either situation as long as the accelerated payment does not significantly increase the present value of the payment absent the acceleration. Even though deferred amounts may currently be earning a rate less than the AFR, there is no

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[56] Prop. Regs. §1.280G-1, Q&A-22(c) and Q&A-24(b).

[57] Prop. Regs. §1.280G-1, Q&A-24(b) and (d) (Example 3).

[58] *See* Prop. Regs. §1.280G-1, Q&A-24(e) (Example 3).

[59] Prop. Regs. §1.280G-1, Q&A-24(c). When calculating the portion of any accelerated payment that must be included as a parachute payment, the applicable federal rate (AFR) to be used is the AFR in effect on the date of the payment. Prop. Regs. §1.280G, Q&A-24(d) and 32. The present value of a payment is generally determined as of the date on which the change in ownership or control occurs, or, if a payment is made prior to such date, the date on which the payment is actually made, using a discount rate equal to 120% of the AFR, compounded semi-annually, on such date. Prop. Regs. §1.280G-1, Q&A-24(d), 31 and 32. However, for any payment, the corporation and the disqualified individual may elect to use the AFR in effect on the date that the contract which provides for the payment is entered into, if such election is made in the contract. Prop. Regs. §1.280G-1, Q&A-32. This allows the drafters of any vested deferred compensation benefit to ensure that the acceleration of payment under such agreement pursuant to a change of control does not give rise to parachute payment consequences. However, this election must be made in the deferred compensation contract itself, and its impact must therefore be considered each time a new deferred compensation agreement is entered into with a disqualified individual. Since it is impossible to know at the time of the drafting of the agreement when a change of control will occur (if ever), and/or the length of the time period during which payment will be accelerated, if the desire is to spell out an interest accrual rate in the plan document and to avoid parachute payment consequences, such interest rate must exceed the greater of the three potentially applicable federal rates (short-term, mid-term or long-term) at the time such contract is entered into.

[60] Prop. Regs. §1.280G-1, Q&A-24(c)(1). It is unclear why the same rule discussed in the text preceding fn. 57, *supra*, does not also apply in this case.

[61] Within the meaning of Regs. §1.83-3(c).

[62] Prop. Regs. §1.280G-1, Q&A-24(c)(2). *Cf. Leberman v. John Blair & Company*, No. 86 CIV. 9077, slip op. (S.D.N.Y., Nov. 24, 1987), reversed, No. 89-7075, slip op., (2d Cir., July 25, 1989).

guarantee that the AFR would have been higher than the earnings accrual rate for such deferred compensation for the entire term of such deferral.

Payments made pursuant to an agreement that is entered into after a change in ownership or control are not treated as contingent on the change. [63] For example, where a disqualified individual who is an employee of a corporation which undergoes a change in control destroys an existing termination agreement, and thereafter enters into a similar employment agreement with the acquiring company, payments to be made under the second agreement should not be treated as contingent on the change since the agreement is entered into after the change in control occurs. [64] However, for this purpose, an agreement that is executed after a change in ownership or control pursuant to a legally enforceable agreement (oral or written) that was entered into *before* the change is considered to have been entered into before the change. In such case, some or all of the payments may nevertheless be exempted from parachute payment status as payments in the form of reasonable compensation for services to be rendered in the future. [65]

The rules discussed above relating to when payments are treated as contingent on a change in control are illustrated by the following examples.

▶ **Example**—*Contingent on Change in Control (1)*

A contract between a corporation and a disqualified individual provides that a payment will be made to the individual if the corporation's level of product sales or profits reaches a specified level. At the time the contract was entered into, the parties had no reason to believe that such an increase in the corporation's level of product sales or profits would be preliminary or subsequent to, or otherwise closely associated with, a change in control of the corporation. Eighteen months later, a change in the ownership of the corporation occurs, and within 1 year after the date of the change, the corporation's level of product sales or profits reaches the specified level. In the absence of contradictory evidence, the increase in product sales or profits of the corporation would not be an event closely associated with the change in control of the corporation. Accordingly, even if the increase is materially related to the change, the payment will not be treated as contingent on a change in control. [66]

▶ **Example**—*Contingent on Change in Control (2)*

A corporation and a disqualified individual enter into a contract providing that upon a change in control of the corporation, all of the nonforfeitable deferred compensation which the individual has earned as of such date will be immediately paid to such individual. The deferred compensation otherwise would be paid when the individual reaches age 60. If a change in the ownership of the corporation occurs on the disqualified individual's 55th birthday in May 1989, and the deferred compensation of $200,000 is immediately paid to such individual, the payment is treated as contingent on the change in control solely because the change accelerates the time at which the payments are made. Since it is substantially certain, at the time of the change, that the payments would have been made whether or not the change occurred, the portion of the payment treated as contingent on the change is $84,893. This is the amount by which the amount of the accelerated payment (*i.e.*, the amount paid to the individual because of the change in control — $200,000) exceeds the present value of the payment absent the acceleration (*i.e.*, the value of the deferred compensation at the time of the change in ownership or control, if the compensation had remained nonpayable until age 60 — $115,107). [67]

Note: This example assumes that the $200,000 of deferred compensation would not otherwise be accruing interest for the next five years had the change of control not occurred. Obviously, if such amount would otherwise be earning interest equal to 120% of the AFR in effect on May 1989, the date of the change of control, there would be no parachute payment consequences because the present value of the payment absent the acceleration would equal the amount of the accelerated payment. Also, if such deferred compensation would otherwise be earning a market rate of interest, so that the amount of the payment absent the acceleration would not be reasonably ascertainable, parachute payment consequences should not arise since it could be assumed that the present value of the compensation is not significantly increased as a result of its accelerated payment date. [68]

▶ **Example**—*Contingent on Change in Control (3)*

A corporation grants a stock appreciation right (SAR) to a disqualified individual. After the SAR vests and becomes exercisable, a change in the ownership of the corporation occurs, and the individual exercises the

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[63] Prop. Regs. §1.280G-1, Q&A-23. Apparently, this is true notwithstanding that certain events occurring within 1 year after a change of control are presumed to be materially related to the change. *See* Prop. Regs. §1.280G-1, Q&A-22(b). Such amounts would not have to constitute reasonable compensation for services to be rendered in the future. *Compare* Prop. Reg. §1.280G-1, Q&A-23(b) (Examples 1 and 2). Of course, to be deductible by the payor corporation, such amounts would have to constitute reasonable compensation. *See* Regs. §1.162(a)(1).

[64] Prop. Regs. §1.280G-1, Q&A-23(b) (Example 1).

[65] Prop. Regs. §1.280G-1, Q&A-23(b) (Example 2), and Q&A-9.

[66] Prop. Regs. §1.280G-1, Q&A-22(e) (Example 3).

[67] Determined using 120% of the AFR for May 1989, or 11.36%, and assuming no election was made to use the AFR in effect when the contract was entered into. *See* Prop. Regs. §1.280G-1, Q&A-24(e) (Example 1) and Q&A-32.

[68] Prop. Regs. §1.280G-1, Q&A-24(e) (Example 3).

1044-7261/90/$0+.50

right. Neither the granting nor the vesting of the SAR was treated as a payment in the nature of compensation, since no amount was includible in the individual's income. [69] Even if the change in ownership accelerates the time at which the right is exercised, no portion of the payment received upon exercise of the right is treated as contingent on the change, since the amount of the accelerated payment does not exceed the present value of the payment absent the acceleration. [70] However, if the SAR generally is exercisable only for stock and upon a change of control it becomes exercisable for cash instead, it would appear that parachute payment consequences could result, since it is likely that the affected disqualified individual would be subject to the insider trading rules, and would, therefore, be receiving the use of cash 6 months sooner than he would have but for the change of control. That is, prior to the change of control, he would have been forced to exercise the SAR for stock, hold the stock for 6 months, and then sell the stock for cash.

▶ **Example**—*Contingent on Change in Control (4)*

As a result of a change in the effective control of a corporation, a disqualified individual receives payment of his vested account balance in a nonqualified individual account plan. Before distribution, actual interest and other earnings on the plan assets were credited to each account as earned, and investment of the plan assets was not restricted so as to prevent the earning of a market rate of return on the plan assets. The date on which the individual would have received his vested account balance absent the change in control is uncertain, and the rate of earnings on the plan assets is not fixed. Under these facts, the amount of the payment absent the acceleration is not reasonably ascertainable, acceleration of the payment does not significantly increase its present value, and the present value of the payment absent the acceleration is treated as equal to the amount of the accelerated payment. Accordingly, no portion of the payment is treated as contingent on the change. [71]

▶ **Example**—*Contingent on Change in Control (5)*

As a result of a change in the effective control of a corporation, a disqualified individual receives payment of his vested benefits under a nonqualified pension plan (*e.g.*, where a certain benefit is promised instead of there being an account balance accruing earnings at a market rate) which he otherwise would have received upon retirement. The amount of the benefits is not actuarially reduced to reflect its earlier payment. The payment is treated as contingent on the change in control solely because the change accelerates the time at which the payment is made. The portion of the payment treated as contingent on the change is the amount by which the amount of the accelerated payment exceeds the actuarially determined present value of the payment absent the acceleration. [72]

▶ **Example**—*Contingent on Change in Control (6)*

On May 15, 1986, a corporation and a disqualified individual enter into a contract providing for a cash payment of $500,000 to be made to the individual on May 15, 1991. The payment is to be forfeited by the individual if he does not remain employed by the corporation for the entire 5-year period. However, the full amount of the payment is to be made immediately upon a change in control of the corporation during such 5-year period. On May 15, 1989, a change in the ownership of the corporation occurs and the full amount of the payment ($500,000) is made on that date to the individual. It is substantially certain, at the time of the change, that the payment would have been made in the absence of the change, since the payment would have been made if the individual had continued to perform services for the corporation until the end of the 5-year period. Therefore, only the sum of: (1) the amount by which the accelerated payment ($500,000) exceeds the present value of the payment that was expected to have been made absent the acceleration ($399,730, [73] the present value on May 16, 1989, of a $500,000 payment on May 15, 1991); and (2) an amount reflecting the lapse of the obligation to continue to perform services is treated as contingent on the change in control. The amount to reflect the lapse of the service requirement will depend on all the facts and circumstances, but in no event will it be less than $115,000 (1% × 23 months × $500,000). Accordingly, the minimum amount of the payment that is treated as contingent on the change in control is $215,270 ($500,000 - $399,730 + $115,000). This result is not changed if the individual actually remains employed until the end of the 5-year period, since the payment is accelerated in any event. [74] There should, however, be no parachute consequence where the receipt of the accelerated payment is optional, and the disqualified individual does not elect to receive such accelerated payment but instead continues employment until May 15, 1991, and receives $500,000 at that time. [75]

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[69] Prop. Regs. §1.280G-1, Q&A-12(a).

[70] Prop. Regs. §1.280G-1, Q&A-24(e) (Example 2).

[71] Prop. Regs. §1.280G-1, Q&A-24(e) (Example 3).

[72] Prop. Regs. §1.280G-1, Q&A-24(e) (Example 4).

[73] Calculated using 120% of the short-term AFR for May 1989, and assuming no election was made to use the AFR in effect on the date the contract was entered into.

[74] Prop. Regs. §1.280G-1, Q&A-24(e) (Example 5).

[75] Note that this example in the proposed regulations is not as favorable as it first appears, since, ignoring present value, $300,000 of this $500,000 has arguably been earned on the date of the change of control, but only $284,730 escapes parachute payment status. *See also* the text preceding fn. 79, *supra*.

▶ **Example**—*Contingent on Change in Control (7)*

On May 15, 1986, a corporation gives to a disqualified individual, in connection with her performance of services for the corporation, a bonus of 1,000 shares of the corporation's stock. Under the terms of the bonus arrangement, the individual is obligated to return the stock to the corporation if she terminates her employment for any reason prior to May 15, 1991. However, if there is a change in control of the corporation prior to May 15, 1991, she ceases to be obligated to return the stock. The individual's rights in the stock are treated as substantially nonvested [76] during that period. On May 15, 1989, a change in the ownership of the corporation occurs. On that day, the fair market value of the stock is $500,000. Since the stock would have become substantially vested in the individual in the absence of the change if she had continued to perform services for the corporation through May 15, 1991, it is substantially certain, at the time of the change, that the payment would have been made absent the change of control. Thus, only the sum of the amount by which the present value of the accelerated payment on May 15, 1989 ($500,000), exceeds the present value of the payment that was expected to have been made on May 15, 1991, absent the acceleration, and an amount reflecting the lapse of the obligation to continue to perform services, is treated as contingent on the change of control. Assuming that, at the time of the change, it cannot be reasonably ascertained what the value of the stock would have been on May 15, 1991, the future value of such stock on May 15, 1991, is deemed to be $500,000, *i.e.*, the value of the stock on May 15, 1989. As in example (6), the present value on May 15, 1989, of a $500,000 payment to be made on May 15, 1991, is $399,730. Thus, the portion of the payment treated as contingent on the change in control is $100,270 ($500,000 - $399,730), plus an amount reflecting the lapse of the obligation to continue to perform services. Such amount will depend on all the facts and circumstances but in no event will be less than $115,000 (1% × 23 months × $500,000). [77] Accordingly, whether the agreement calls for payment in cash or payment in stock, the parachute consequences are the same where the value of the stock on the date of the change is equal to the amount of the cash payment. [78] However, this appears to impose double parachute consequences where both vesting and payment is accelerated. Compare the result where only payment is accelerated and the future value is not reasonably ascertainable. In that case, no parachute consequences result with respect to the accelerated payment. [79]

▶ **Example**—*Contingent on Change in Control (8)*

On May 15, 1986, a corporation grants to a disqualified individual nonqualified stock options to purchase 30,000 shares of the corporation's stock. The options do not have a readily ascertainable fair market value at the time of grant. The options will be forfeited by the individual if he fails to perform personal services for the corporation until May 15, 1991. The options will, however, substantially vest in the individual at an earlier date if there is a change in control of the corporation. On May 16, 1989, when the options have an ascertainable fair market value of $500,000, a change in the ownership of the corporation occurs and the options become substantially vested in the individual. At the time of the change, it is substantially certain that the payment of the options to purchase 30,000 shares would have been made in the absence of the change if the individual had continued to perform services for the corporation until May 15, 1991. Therefore, the portion of the payment that is treated as contingent on the change is the sum of the amount by which the amount of the accelerated payment on May 15, 1989 ($500,000) exceeds the present value on May 15, 1989 of the payment that was expected to have been made on May 15, 1991, absent the acceleration, and an amount reflecting the lapse of the obligation to continue to perform services. Assuming that, at the time of the change, it cannot be reasonably ascertained what the value of the options would have been on May 15, 1991, the value of such options on May 15, 1991, is deemed to be $500,000, the value of such options on May 15, 1989. As in example (6) above, the present value on May 15, 1989, of a $500,000 payment to be made on May 15, 1991, is $399,730. Thus, the portion of the payment treated as contingent on the change is $100,270 ($500,000 - $399,730), plus an amount reflecting the lapse of the obligation to continue to perform services. Such amount will depend on all the facts and circumstances but in no event will such amount be less than $115,000 (1% × 23 months × $500,000). Thus, the total parachute payments are again $215,270 ($100,270 + $115,000). [80] Accordingly, whether the agreement calls for payment in cash or stock, or nonqualified stock options, if the value of the stock and/or the value of the nonqualified stock options on the date of the change equals the amount of the cash payment, the parachute consequences are identical.

▶ **Example**—*Contingent on Change in Control (9)*

Assume the same facts as in example (8), except that the options become substantially vested periodically (absent a change in ownership of control), with one-

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[76] Within the meaning of Regs. §1.83-3(b).

[77] Prop. Regs. §1.280G-1, Q&A-24(e) (Example 6).

[78] Prop. Regs. §1.280G-1, Q&A-24(e) (Example 5).

[79] Prop. Regs. §1.280G-1, Q&A-24(b). *See* fn. 60, *supra*.

[80] Prop. Regs. §1.280G-1, Q&A-24(e) (Example 7). *See also* the text preceding fn. 79, *supra*.

1044-7261/90/$0+.50

third of the options vesting on May 14, 1988, May 14, 1989, and May 14, 1990, respectively. Thus, options to purchase 20,000 shares vest independently of the May 15, 1989 change in ownership, and the options to purchase the remaining 10,000 shares vest as a result of such change of control. At the time of the change, it is substantially certain that the payment of the options to purchase 10,000 shares would have been made without regard to the change of control if the individual had continued to perform services for the corporation until May 15, 1991. Therefore, the portion of the payment that is treated as contingent on the change is the sum of the amount by which the accelerated payment on May 15, 1989 ($166,667) exceeds the present value on May 15, 1989 of the payment that was expected to have been made on May 15, 1991, absent the acceleration, and an amount reflecting the lapse of the obligation to continue to perform services. Assuming that, at the time of the change of control, it cannot be reasonably ascertained what the value of the options would have been on May 15, 1991, the value of such options on May 15, 1991, is deemed to be $166,667 (*i.e.*, the value of such options on May 15, 1989). The present value[81] on May 15, 1989, of a $166,667 payment to be made on May 15, 1991, is $133,243. Thus, the portion of the payment treated as contingent on the change is $33,424 ($166,667 – $133,243), plus an amount reflecting the lapse of the obligation to continue to perform services. Such amount will depend on all the facts and circumstances but in no event will it be less than $38,333 (1% × 23 months × $166,667).[82] As this example illustrates, the parachute payment consequences can be significantly decreased by graded vesting of nonqualified stock options (compared to cliff vesting). However, this is done at a greater cost to the corporation should the executive decide to terminate employment before a change of control occurs.

▶ **Example**—*Contingent on Change in Control (10)*

Assume the same facts as in examples (8) and (9), except that the option agreement provides that the options will vest either upon the corporation's level of profits reaching a specified level, or if earlier, on the date on which there is a change in control of the corporation. The corporation's level of profits do not reach the specified level prior to May 15, 1989. In such case, the full amount of the payment, $500,000, is treated as contingent on the change of control because it was not substantially certain, at the time of the change of control, that the payment would have been made (absent the change) if the individual had continued to perform services for the corporation for a specified period of time.[83] However, some portion of this parachute payment may presumably be offset against any excess parachute payments to the extent it is established to be reasonable compensation for personal services actually rendered before the date of a change in ownership or control and exceeds the base amount allocable to such payment.

▶ **Example**—*Contingent on Change in Control (11)*

The accelerated payment of fully vested deferred compensation might give rise to parachute payment consequences where: (1) an accelerated lump-sum payment is made with respect to benefits under a defined benefit-type nonqualified plan in an amount equal to the actuarial equivalent of the monthly payments that would have been made if an annuity had been elected, but there is no actuarial reduction to take into account that more payments would have been received under the annuity option if the benefits had begun on the date of the accelerated lump-sum payment;[84] (2) an accelerated lump-sum payment is made from a defined contribution-type nonqualified plan, and when calculating the lump-sum payment, either the fixed assumed earnings rate used to arrive at the projected future value[85] or the rate to discount that projected future value back to present value is not at least equal to 120% of the AFR;[86] or (3) an accelerated lump-sum payment is made from a defined contribution-type nonqualified plan, and the fixed interest rate which such vested deferred compensation would have earned under the plan is *less than* 120% of the AFR (as of the date of the change of control, or the date the contract was executed, whichever applies).

Note: These examples indicate that the standard for a "contingent" payment[87] is extremely broad and includes a number of types of payments that might not ordinarily be regarded as parachute payments. Even vested deferred incentive compensation or ordinary severance pay paid because an employee is terminated are treated as contingent upon a change of control where the

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[81] *See* fn. 67, *supra*.

[82] Prop. Regs. §1.280G-1, Q&A-24(e) (Example 8). *See also* the text preceding fn. 79, *supra*.

[83] Prop. Regs. §1.280G-1, Q&A-24(e) (Example 9).

[84] S. Rep. No. 313, 99th Cong., 2d Sess. 916 (1986).

[85] This will not necessarily be true if the earnings rate used for calculating such lump-sum payment is not the same as the normal earnings accrual rate of the plan for such vested deferred compensation.

[86] Accordingly, in the case of any lump-sum payments accelerated by a change of control, individual calculations may be necessary to determine the golden parachute consequences, if any, of those payments. These golden parachute consequences will depend on the interest rate assumptions used to accumulate deferred amounts as of the date of the change of control to the time payment would have been made under the plan, and the interest rate used to discount that amount back to the actual time of the lump-sum payment.

[87] Prop. Regs. §1.280G-1, Q&A-22.

employee's termination of employment is closely associated with and materially related to such change of control. In fact, it is likely that the provision of a benefit in all cases upon the termination of a plan, like the provision of a benefit in all cases upon termination of employment, will give rise to parachute consequences where the plan termination is closely associated with and materially related to the change of control. In both cases, however, Prop. Regs. §1.280G-1, Q&A-24 may eliminate some, but not necessarily all, of the inequities of the proposed regulations in those situations. In at least one reported case, amounts that would have been paid in any event did not constitute parachute payments, even where vesting was accelerated. [88]

¶ 5720.03.C
Aggregate Present Value of Contingent Payments Equals or Exceeds a Certain Threshold (Three Times Base Amount)

Not all payments that are (1) in the nature of compensation, (2) made to a disqualified individual, and (3) contingent on a change in ownership or control constitute parachute payments. The mathematical determination of parachute payments also requires that the aggregate present value of all payments in the nature of compensation that are contingent upon the change and that are made to the same disqualified individual exceed a certain threshold. For this purpose, future payments are taken into account at their present value. [89] If this aggregate present value equals or exceeds the amount equal to three times the individual's base amount, some portion of the payments are excess parachute payments. If this aggregate present value is less than the amount equal to three times the individual's base amount, no portion of the payments is an excess parachute payment. Parachute payments that are securities violation parachute payments are not included in this computation if they are not contingent on a change in control. [90]

In certain cases, it may be necessary to apply the three-times-base-amount threshold or to allocate a portion of the base amount to a payment at a time when the aggregate present value of all such payments cannot be determined with certainty because the time, amount, or right to receive one or more such payments is contingent on the occurrence of an uncertain future event or condition. For example, a disqualified individual's right to receive a payment may be contingent on the involuntary termination of such individual's employment with the corporation. In such a situation, a reasonable estimate of the time and amount of the future payment must be made, and the present value of the payment is determined on the basis of this estimate. [91] For purposes of making this estimate, an uncertain future event or condition that may reduce the present value of a payment is taken into account only if the possibility of the occurrence of the event or condition can be determined on the basis of generally accepted actuarial principles or can be otherwise estimated with reasonable accuracy. [92]

Whenever a payment, the timing, amount or right to ultimate receipt of which is uncertain, is actually made or becomes certain not to be made, the three-times-base-amount test is to be reapplied (and the portion of the base amount allocated to previous payments is reallocated, if necessary, to such payments) to reflect the actual time and amount of the payment. [93] Whenever the three-times-base-amount test is reapplied (or whenever the base amount is reallocated), the aggregate present value of the payments received or to be received by the disqualified individual is redetermined, potentially affecting the amount of any excess parachute payment for a prior taxable year. [94]

Note: By making the estimate of the likelihood of an uncertain future event completely dependent on the events that actually occur, it is impossible for a corporation to accurately calculate, for planning purposes, the total parachute payments, when the time, amount or right to receive one or more payments is contingent on the occurrence of some future event or condition. Thus, even where the possibility of the occurrence of the relevant event or condition can be reasonably determined on the basis of generally accepted actuarial principles or otherwise, such an estimate is of no significance if the events or conditions do not occur as projected.

▶ **Example**—*Recalculation of Present Value (1)*

B, a disqualified individual with respect to Corporation N, has a base amount of $100,000. Under her employment agreement with N, B is entitled to receive payments in the nature of compensation in the amount of $20,000 per month for a period of 24 months if B terminates employment with N as a result of a change

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[88] *Leberman v. John Blair & Co.*, No. 86 CIV. 9077, slip op. (S.D.N.Y., Nov. 24, 1987), rev'd and remanded as inappropriate for summary judgment, No. 89-7075, slip op. (2d Cir., July 25, 1989). *See also Sullivan v. Easco Corp.* 662 F. Supp. 1396 (D. Md. 1987), where the court suggested that a showing that a payment was made prior to a change in control would rebut the 1-year presumption even where such payment was made pursuant to a contract entered into within 1 year before the change. The IRS has not, however, followed these cases in its proposed golden parachute regulations.

[89] The present value of a payment is determined as of the date on which the change in ownership occurs, or, if a payment is made prior to such date, the date on which the payment is made. *See* Prop. Regs. §1.280G-1, Q&A-31. As discussed *supra*, the AFR to be used is that which is in effect on the date as of which the present value is determined, provided that the company and the disqualified individual have not taken advantage of the special election to utilize the rate in effect on the date that such contract was entered into. *See* Prop. Regs. §1.280G-1, Q&A-32.

[90] Prop. Regs. §1.280G-1, Q&A-30(a).

[91] Prop. Regs. §1.280G-1, Q&A-33(a).

[92] *Id.*

[93] Prop. Regs. §1.280G-1, Q&A-33(b).

[94] *Id.*

1044-7261/90/$0+.50

in control of N. Such monthly payments are to be reduced by the amount of any compensation earned by B from unrelated employers during the 24-month period. B and N are calendar year taxpayers. On Feb. 1, 1989, there is a change in control of N. As a result of the change, B voluntarily terminates employment with N and begins to receive monthly payments under the agreement. Assume that the present value, determined as of Feb. 1, 1989, of a stream of 24 monthly payments of $20,000, is $434,256.[95] At the time N files its income tax return for 1989, it cannot be determined with reasonable accuracy whether B will earn any compensation from unrelated employers during the 24-month period. Accordingly, the present value of the payments to be received by B ($434,256) exceeds 3 times B's base amount ($300,000), and a portion of each of the 1989 payments will be treated as an excess parachute payment for the 1989 taxable year. If, however, when the contract becomes operative, it is reasonable to assume that B will earn compensation of $10,000 per month as compensation from an unrelated corporation, the present value of the payments to be received is $217,128,[96] which does not exceed 3 times the base amount, and therefore, none of the 1989 payments need to be treated as excess parachute payments. If B does not actually receive $10,000 per month as compensation from an unrelated corporation, however, the golden parachute consequences must be redetermined based on the actual events that transpire, and if the redetermination results in golden parachute consequences, both she and N will need to file amended 1989 tax returns.

▶ **Example**—*Recalculation of Present Value (2)*

Assume the same facts as in example (1). Also assume that it cannot be determined with reasonable accuracy whether B will receive compensation from unrelated employers. Finally, assume that in Apr. 1990, B becomes employed by an employer unrelated to N at the rate of $20,000 per month. Under this scenario, at the time N files its income tax return for 1990 (assuming it requested an automatic extension), it has become certain that, due to the compensation earned by B from unrelated employers, the present value, determined as of Feb. 1, 1989, of the stream of payments from N will not exceed $264,456.[97] Since it can then be redetermined that the present value of the payments received or to be received by B does not equal or exceed 3 times B's base amount, no portion of the payments made in 1989 or 1990 will be treated as excess parachute payments under either situation. Presumably, however, both N and B would need to wait to amend their 1989 returns (if they had already been filed) to see whether B keeps this new job until Feb. 1991. Where N actually files its tax return on June 15, 1990 (pursuant to an extended deadline of Sept. 15, 1990), and B does not yet have a new job, it would appear that some portion of the 1989 and 1990 payments should be treated as parachute payments, since it is certain at such time that the total present value of the payments to be received by B will be at least $316,980.[98]

Note: These examples illustrate that the end result for federal income tax purposes is the same whether or not the likelihood of occurrence of the future event or condition is reasonably determinable, since the actual events which happen will ultimately control the tax consequences in either case. There is, however, a significant difference where the likelihood of the occurrence of the future event or condition is reasonably determined to be less than what actually occurs. If the statute of limitations has run when events actually occur, the ability to reasonably estimate the likelihood of such events occurring effectively eliminates the golden parachute consequences since the IRS has no authority in that situation to extend the statute of limitations.

¶ 5720.03.D Determination of the Base Amount

1. Computation

As discussed above, the last step in applying the mathematical parachute payment test is determining whether the total present value of compensation-type contingent payments to disqualified individuals equals or exceeds the threshold amount (*i.e.*, three times the base amount). Making this determination requires a calculation of the base amount. The base amount of a disqualified individual is the average annual compensation[99] which was includible in the gross income of such individual for taxable years in the "base period."[100] Since the base amount includes only compensation that is includible in gross income, the base amount does not include certain items that constitute parachute payments. For example, payments in the form of untaxed fringe benefits and compensation, the payment of which is deferred until after the change of control, are not included in the base amount but may be treated as parachute payments.[101]

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[95] Determined using 10.91% interest (120% of the short-term AFR for Feb. 1989). Note that this calculation was made by compounding these monthly payments on a semi-annual basis (rather than a monthly basis), as apparently mandated by Prop. Regs. §1.280G-1, Q&A-32.

[96] *Id.*

[97] *Id.*

[98] *Id.*

[99] As defined in Prop. Regs. §1.280G-1, Q&A-21.

[100] Prop. Regs. §1.280G-1, Q&A-34(a). Also considered are amounts which were excludable from such gross income as "foreign earned income" within the meaning of §911, or would have been includible in such gross income if such person had been a United States citizen or resident.

[101] Prop. Regs. §1.280G-1, Q&A-34(c).

The "base period" of a disqualified individual is the most recent five taxable years (generally calendar years) of the individual ending before the date of the change in ownership or control. However, if the disqualified individual was not an employee or independent contractor of the corporation with respect to which the change in ownership or control occurs (or a predecessor entity or a related entity) [102] for this entire five-year period, the individual's base period is the portion of such five-year period during which the individual performed personal services for the corporation or predecessor entity or related entity. [103]

Note: As can be seen from the definition of the base period, since compensation for the most recent five taxable years must be averaged when determining base amount, an executive's base amount may be substantially less than the rate of compensation that he is receiving at the time the change of control occurs. Additionally, base period years in which the employee was not a disqualified individual are not removed from the base period. Thus, executives who have recently been promoted to the status of disqualified individuals may have non-disqualified individual years which are included in their base period during which their compensation was extremely disproportionate to their compensation as of the date of the change of control. Finally, the aggregation by the proposed regulations of compensation received from related companies will also generally result in reduced base amount, since it will include compensation paid in earlier periods in determining the disqualified individual's average includible compensation. If such compensation were not included, the base amount would be determined by averaging more current compensation, which would probably result in a higher base amount. Such aggregation is necessary, however, to prevent the base amount limitation from being avoided by transferring executives to a different subsidiary once a change of control is imminent. As a result of all of the rules which work against the disqualified individuals and in effect reduce their base amount, it would appear that if non-parachute includible income (*e.g.*, W-2 income) in the year of the change of control is greater than the average includible income for the five prior taxable years of the disqualified individual, it should be includible on an annualized basis as part of the base amount determination. This treatment is consistent with the treatment for an employee not employed prior to the year of the change in control. Not to allow such a determination of the base amount in essence discriminates against those employees who have been employed by the payor corporation for a longer period of time.

If the base period of a disqualified individual includes a short taxable year or less than all of a taxable year, compensation for such short or incomplete taxable year must be annualized before determining the average annual compensation for the base period. When annualizing compensation, the frequency with which payments are expected to be made over an annual period must be taken into account. Thus, any amount of compensation for a short or incomplete taxable year that represents a payment that will not be made more often than once per year is not annualized. [104]

▶ **Example**—*Base Amount (1)*

A disqualified individual was employed by a corporation for 2 years and 4 months preceding the taxable year in which a change in control of the corporation occurred. The individual's includible compensation income from the corporation was $30,000 for the 4-month period, $120,000 for the first full year and $150,000 for the second full year. The individual's base amount is $120,000. [105] If the same individual also received a $60,000 "sign-up" bonus when his employment with the corporation commenced at the beginning of the 4-month period, the individual's base amount would be $140,000. [106] Since the sign-up bonus would have not been paid more often than once per year, the amount of the bonus is not increased when annualizing the individual's compensation for the 4-month period. [107] This example shows that the use of a sign-up bonus can substantially increase the base amount.

If a disqualified individual did not perform services for the corporation (or a predecessor entity or a related entity) prior to the individual's taxable year in which the change in ownership or control occurs, such individual's base amount is the annualized compensation which:

- was includible in the individual's gross income for that portion (prior to the change) of the individual's taxable year in which the change occurred;
- was not contingent on the change in ownership or control; and
- was not a securities violation parachute payment. [108]

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[102] As defined in Prop. Regs. §1.280G-1, Q&A-21.

[103] Prop. Regs. §1.280G-1, Q&A-35(a).

[104] Prop. Regs. §1.280G-1, Q&A-34(b).

[105] ((3 × 30,000) + 120,000 + 150,000), divided by 3.

[106] (($60,000 + (3 × $30,000)) + $120,000 + $150,000), divided by 3.

[107] Prop. Regs. §1.280G-1, Q&A-35(b). (Examples 1 and 2).

[108] Prop. Regs. §1.280G-1, Q&A-36(a). Contrary to the general rule when determining base amount, payments contingent on the change of control are not included in the base amount for purposes of this special rule. Under the general rule, parachute payments by the corporation acquired pursuant to the change of control (or by affiliated or predecessor corporations) would be included in a disqualified individual's base amount when such payments were made during the 5 calendar years preceding the change of control. Generally, however, since the base amount is calculated by reference to only the full calendar years preceding the change of control, and since a change of controls seldom overlaps 2 calendar years, the general definition of the base amount determination period effectively eliminates any parachute payments from the base amount determination.

1044-7261/90/$0+.50

Note: Because of these special rules for short-term employees, the use of a five-year base amount determination period results in adverse treatment of long-term employees versus short-term employees. For example, assuming generally increasing responsibilities and pay over time, a one-year employee with the same base salary as a five-year employee will generally have a substantially higher base amount than the five-year employee.

▶ **Example**—*Base Amount (2)*

To illustrate this special rule, assume that on Jan. 1, 1986, A, an individual whose taxable year is the calendar year, enters into a 4-year employment contract with Corporation M as an officer of the corporation. A has not previously performed services for M (or any predecessor entity or related entity). Under the employment contract, A is to receive an annual salary of $120,000 for each of the 4 years that he remains employed by M with any remaining unpaid balance to be paid immediately in the event that A's employment is terminated without cause. On July 1, 1986, after A has received compensation of $60,000, a change in the ownership of M occurs. Due to the change of control, A's employment is terminated without cause, and he receives a payment of $420,000. It is established by clear and convincing evidence that the $60,000 of compensation received by A prior to the change of control was not contingent on the change in ownership or control, but the 1-year presumption is not rebutted with respect to the $420,000 payment.[109] Thus, the payment of $420,000 is treated as contingent on the change in ownership of M.[110] In this case, A's base amount is $120,000 (2 × $60,000). Since the present value of the payment which is contingent on the change in ownership of M ($420,000) is more than 3 times A's base amount, or $360,000 ($120,000 × 3), the entire $420,000 payment is a parachute payment.

▶ **Example**—*Base Amount (3)*

Assume the same facts as in example (2), except that A also receives, on Jan. 1, 1986, a $50,000 sign-up bonus from M. Assume further that it is established by clear and convincing evidence that the sign-up bonus is not contingent on the change in ownership. When the change in ownership occurs on July 1, 1986, A has received compensation of $110,000 (the $50,000 bonus plus $60,000 in salary). In this case, A's base amount is $170,000.[111] The present value of the potential parachute payment ($420,000) is now less than 3 times A's base amount of $510,000, (3 × $170,000), and therefore, no portion of the payment is a parachute payment. Thus, by utilizing the large sign-up bonus for the disqualified individual, the corporation effectively avoided parachute payment consequences.

Note: The base amount includes not only an individual's base salary but also non-deferred amounts (or distributions of previously deferred amounts) under annual incentive, long-term performance and profit-sharing plans, as well as ordinary income recognized with respect to stock options. The base amount does, however, generally exclude deferred amounts that are not yet payable or taxable.[112] Although the base amount excludes nontaxable deferred benefits earned during the base years, those same nontaxable benefits may constitute parachute payments if they are received upon termination of employment following a change in control, or their vesting and/or payment is accelerated by the change. Therefore, the deferral of income by an executive can have the adverse consequences of both reducing the base amount and lumping all of those previously deferred amounts into one basket as potential parachute payments. In certain circumstances, therefore, it may be desirable to accelerate income (*e.g.*, accelerate the receipt of payments under deferred compensation arrangements, exercise stock appreciation rights, exercise nonqualified stock options, or make disqualifying dispositions of stock acquired using incentive stock options) into the disqualified individual's taxable year preceding the year of the change of control where it is possible to do so because the change of control overlaps two calendar years. For example, the rules discussed *supra* for computing the base amount could potentially treat incentive stock option (ISO) exercises differently for parachute calculation purposes and base amount calculation purposes. If a spread with respect to an ISO can be a parachute, the value of ISOs exercised in the five prior taxable years should be includible in the base amount. This is not generally the case, however, since income with respect to the exercise of ISOs only occurs when the related stock is sold.[113]

2. Planning Opportunities

The above described method of computing the base amount has the following results. First, a disqualified individual's average annual compensation for the five taxable years preceding a change of control will generally be significantly understated for the reasons described above. Second, a disqualified individual's elective deferral of compensation under nonqualified deferred com-

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[109] Prop. Regs. §1.280G-1, Q&A-25.

[110] Presumably, the payment does not qualify under Prop. Regs. §1.280G-1, Q&A-42(b) as reasonable compensation for services to be rendered because the damages exceed the present value of the compensation the individual would have received under the contract.

[111] $50,000 + (2 × $60,000). Note that since the sign-up bonus is a one-time payment, it is not annualized.

[112] *Compare* the treatment of qualified elective deferrals in Prop. Regs. §1.280G-1, Q&A-21(a).

[113] Note that ISOs which are qualified under §422A are not counted as taxable income for W-2 purposes.

pensation programs, delay of the exercise of stock options, etc. will reduce such person's average annual compensation, and thus his "safe harbor" amount. Third, the annualization of a partial year's compensation for a disqualified individual who has less than five full taxable years of compensation preceding a change of control will also tend to understate such person's true average annual income, since the year's income which will be annualized will normally be the person's first year of employment with the corporation (likely to be the year in which the person's compensation from the corporation was the lowest).

Despite the general negative impact of the base amount determination rules, some limited planning opportunities to increase the base amount are available. Since the base amount is set as of the end of the last taxable year ending before the year of the change of control, no planning opportunities to increase the base amount are generally available immediately before the change of control unless the threatened change of control begins in or is known about in one taxable year (generally the calendar year) and the actual change of control occurs in the following taxable year. Some possible planning opportunities include the following:

- To the extent that a person has a parachute agreement which foreseeably may be triggered, such individual may find it advantageous not to delay the receipt of income to the maximum extent possible, but rather to accelerate the receipt of such potential parachute payments prior to the change of control to assure the highest possible recognition of income within the relevant five year averaging period. The adverse consequence of such acceleration of income in the event that no change of control occurs is the accelerated payment of tax on such income.

- Once a change in control becomes imminent, to the extent there is the opportunity to bunch or accelerate income through the exercise of options (or the sale of shares obtained by exercising options), the receipt of deferred compensation, or any other method, it may be desirable to do so to the extent that income can be recognized in a taxable year prior to the year of the change of control. Again, the adverse consequence is the accelerated payment of tax on such income should the change of control not occur.

- Delaying the change of control to the extent possible is generally desirable. This may not only help in allowing the accelerated receipt of taxable compensation (increasing includible compensation for the last year of the "base year determination period"), but it may also substantially reduce the parachute tax exposure by eliminating a lower earlier year of compensation from the five year determination period and substituting in its place a current year with much higher compensation.

¶ 5720.03.E
Treatment of Transfers of Property and Stock Options for Golden Parachute Purposes

The Code [114] suggests that property transferred in connection with a change in control (whether or not it is subject to a substantial risk of forfeiture) could be treated as a current payment and taken into account at its fair market value value whether or not it is currently includible in income. However, under the proposed regulations, a transfer of property is generally considered a payment made (or to be made) in the taxable year in which the transferred property is includible in the gross income of the disqualified individual. [115] Such a payment is generally considered made when the property is transferred [116] to the disqualified individual and becomes substantially vested [117] in such individual. The amount of the payment is generally determined under the provisions regarding the transfer of restricted property, [118] and is generally equal to the excess of the fair market value of the transferred property [119] at the time that the property becomes substantially vested, over the amount (if any) paid for the property. An election made by a disqualified individual to accelerate the time at which such property is taxed [120] will not, however, be effective for purposes of the golden parachute provisions. [121] Thus, even if such an election is made with respect to a property transfer that is a payment in the nature of compensation, the payment related to that property transfer will generally be considered made when the property is transferred to, and becomes substantially vested in, such individual, rather than when such election is made.

Since SARs are not property rights and are not technically subject to the transfer of property rules, [122] an SAR should not be treated as a "payment" for parachute purposes until it is exercised. Thus, if an SAR is

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[114] §280G(d)(3).

[115] Prop. Regs. §1.280G-1, Q&A-12(a). *See also* §83 and the regulations thereunder, ¶ 5710.04.E, *supra*, and 384 T.M., *Restricted Property — §83*. In fact, the proposed golden parachute regulations exempt from parachute payment status any unexercisable (but vested) options or SARs that become exercisable on account of a change in control. Accordingly, stock options and SARs that are vested at the time of a change of control, but are subject to restrictions under §16(b) of the Securities and Exchange Act of 1934, should not be treated as parachute payments if they are cashed out upon a change of control (provided the accelerated payment does not result in increased value (*see* the discussion in ¶ 5720.03.B, *supra*).

[116] As defined in Regs. §1.83-3(a).

[117] As defined in Regs. §1.83-3(b).

[118] As described in §83 and the regulations thereunder. *See* ¶ 5710.04.E, *supra*.

[119] Determined without regard to any lapse restriction, as defined in Regs. §1.83-3(i).

[120] Pursuant to §83(b).

[121] Pursuant to Prop. Regs. §1.280G-1, Q&A-12(b).

[122] *See* §83; Regs. §1.83-3(e).

1044-7261/90/$0+.50

vested on account of a change in control, but not exercised until some time after the change of control, the disqualified individual may be able to reduce the amount of the SAR that is ultimately considered a parachute payment by delaying exercise of such SAR. [123]

▶ **Example**—*Treatment of Property Transfers*

On Jan. 1, 1986, Corporation M, in connection with A's performance of services for it, gave A a bonus of 100 shares of M stock. Under the terms of the bonus arrangement, A is obligated to return the stock to M unless the earnings of M double by Jan. 1, 1989, or there is a change in control of M before that date. A's rights in the stock are treated as substantially nonvested [124] during 1986 through 1988 because A's rights in the stock are subject to a substantial risk of forfeiture [125] and are nontransferable. [126] On Jan. 1, 1988, a change in the ownership of M occurs. On that day, the fair market value of the M stock is $250 per share. Since A's rights in the M stock become substantially vested [127] on that day, the payment is considered made to A on that day for golden parachute purposes, and the amount of the payment for such purposes is $25,000 (100 × $250). [128] If, however, the earnings of M had doubled prior to the date of the change of control, presumably only the portion of the payment relating to the acceleration of the time of payment would be a parachute payment. [129]

The treatment of stock options, whether qualified (ISOs) [130] or nonqualified (NQSOs), [131] for golden parachute purposes is not as clear as the treatment of other property transfers. Perhaps the most important consideration in resolving the issue of how to treat stock options for golden parachute purposes relates to whether normal transfer of property concepts [132] should be used in determining whether a payment is made when stock options are involved. Other considerations relate to the general loss of the corporate deduction with respect to ISOs (notwithstanding the golden parachute provisions), and the timing of the income inclusion for both ISOs and NQSOs.

The proposed golden parachute regulations generally adopt the normal transfer of property rules in the case of NQSOs. [133] However, the treatment of NQSOs differs from the treatment of other property transfers [134] in that the option is not required to have a readily ascertainable fair market value to be a parachute payment. However, a retroactive redetermination of parachute payment consequences is necessary where the NQSO does not have an ascertainable fair market value at the time of accelerated vesting upon a change of control. [135] As is true for other property transfers, the proposed regulations ignore elections made by disqualified individuals to accelerate the time at which NQSOs will be taxed to them are ignored for purposes of the golden parachute rules. [136] Presumably because of the different tax consequences to the grantor and grantee of ISOs (compared to NQSOs), the proposed regulations do not adopt any rules with respect to the treatment of ISOs for golden parachute purposes. [137]

For NQSOs that have an ascertainable fair market value (whether or not readily ascertainable) [138] at the time the option becomes substantially vested, [139] the option is treated as property that is transferred not later than the time at which the option becomes substantially vested. [140] Thus, for purposes of the golden parachute

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[123] This result occurs because any delay in exercise automatically reduces the discounted present value of the accelerated payment. However, the value attributable to the waiver of the obligation to continue to perform services apparently does not change since Prop. Regs. §1.280G-1, Q&A-24 (Example 5) indicates that the value of the waiver of the continued service obligation does not change if the individual actually remains employed until the normal payment date.

[124] Within the meaning of Regs. §1.83-3(b).

[125] Within the meaning of Regs. §1.83-3(c).

[126] Within the meaning of Regs. §1.83-3(d).

[127] Within the meaning of Regs. §1.83-3(b).

[128] For rules relating to the reduction of the excess parachute payments by the portion of the payment that is established to be reasonable compensation for personal services actually rendered before the date of the change in ownership or control, *see* ¶ 5720.05.A, *infra*. *See also* Prop. Regs. §1.280G-1, Q&A-12(d).

[129] Prop. Regs. §1.280G-1, Q&A-24 (Example 9).

[130] §§421 & 422A. For a discussion of ISOs, *see* ¶ 5820, *infra*, and 7 T.M., *Stock Options (Statutory) — Qualifications*.

[131] For a discussion of NQSOs, *see* ¶ 5810, *infra*, and 383 T.M., *Nonstatutory Stock Options*.

[132] §83.

[133] Prop. Regs. §1.280G-1, Q&A-13.

[134] Where the general §83 rules are also utilized, except for the refusal to consider §83(b) elections.

[135] Prop. Regs. §1.280G-1, Q&A-13. For a detailed discussion of the problems related to an after-the-fact determination of golden parachute consequences which are dependent upon uncertain future events, see the discussion in ¶ 5720.03.C, *supra*.

[136] Thus, elections that were made by a disqualified individual in a year prior to the change in control to include transferred property in income would increase such disqualified individual's income for such year (presumably also increasing such disqualified individual's base amount). However, these elections would not prevent such property from being parachute payments if any forfeiture conditions were waived on account of a change in control. Moreover, since under the §83 rules, a "payment" with respect to property is not deemed to occur until the property becomes substantially vested, where a disqualified individual receives unvested property rights "payment" of which is contingent upon a change of control, the amount of the parachute payment arguably cannot be decreased by making a §83(b) election. It seems inappropriate, however, to ignore §83(b) elections when the transfer of property, as opposed to its vesting, is contingent on the change of control.

[137] Prop. Regs. §1.280G-1, Q&A-13(c).

[138] As defined in Regs. §1.83-7(b).

[139] As defined in Regs. §1.83-3(b).

[140] Prop. Regs. §1.280G-1, Q&A-13(a).

provisions, the vesting of such NQSOs is treated as a payment in the nature of compensaton. [141] For the treatment of NQSOs the vesting of which is contingent on a change in ownership or control and that do not have an ascertainable fair market value at the time of vesting, the rules are the same as those applicable to the valuation of payments contingent on an uncertain future event or condition. [142] This would appear to allow an actuarial estimate of the parachute consequences attributable to such NQSOs but would also require recalculation of such parachute consequences on an after-the-fact basis once it is determined whether or not such NQSOs had an "ascertainable fair market value" at the time of the accelerated vesting upon a change of control. [143]

Any money or other property transferred to the disqualified individual upon the exercise, or as consideration upon the sale or other disposition, of an NQSO after the time such option vests is not treated as a payment in the nature of compensation to the disqualified individual for purposes of the golden parachute provisions. Nevertheless, the amount of the otherwise allowable corporate deduction with respect to such transfer is reduced by the amount of any payment with respect to such NQSO that has been treated as an excess parachute payment. [144]

Note: Under the proposed regulations, vested options (or SARs) that are exercised upon a change in control are only considered parachute payments to the extent of the accelerated portion. The rationale for this result is that because the former employee is entitled to exercise the option or SAR anyway, the full amount should not be considered a parachute payment. Options, SARs, and deferred compensation that are not vested or exercisable are to be treated differently, the rationale being that the employee was not entitled to them except for the change in control. Since the treatment of the entire value of unvested options as parachute payments would have caused the three-times-base-amount threshold to be exceeded for many executives with the parachute payments attributable to the value of options alone, the proposed regulations essentially treat unvested compensation in the form of options, SARs, and other deferred compensation as earned to the extent the vesting period has run. Accordingly, only the discounted present value of the compensation for the unexpired vesting period is included in the parachute calculation, *i.e.*, only the value of the acceleration plus 1% per month (to reflect the removal of the obligation to continue to perform services) is included in the parachute calculation.

¶ 5720.03.F
Presumption That Payment Is Contingent on Change (One-Year Presumption)

Any payment pursuant to either an agreement or a significant amendment of a previous agreement that is entered into within one year before a change in ownership or control is presumed to be contingent on such change unless the contrary is established by "clear and convincing evidence." However, in the latter situation, only the portion of the payment that exceeds the amount of such payment that would have been made in the absence of the amendment is presumed, by reason of the amendment, to be contingent on the charge in ownership or control. [145] To rebut this presumption, the taxpayer must establish by clear and convincing evidence that the payment is not contingent on the change in control. Whether the payment is contingent on such change is determined on the basis of all the facts and circumstances of the particular case. Factors relevant to such a determination include, but are not limited to: (1) the content of the agreement or amendment; and (2) the circumstances surrounding the execution of the agreement or amendment, such as whether it was entered into at a time when a takeover attempt had commenced and the degree of likelihood that a change in ownership or control would actually occur. [146] Thus, to rebut the presumption, a taxpayer might demonstrate, for example, either that the takeover offer came as a complete surprise, or that the contract in question was one which is routinely entered into *(e.g.,* an annually renewable employment contract or standard contract for a new executive).

Several specific exceptions to the one-year presumption are provided. [147] These require a showing by clear and convincing evidence that the agreement is:

- a nondiscriminatory employee plan or program; [148]

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[141] It is likely that options will be treated as having an ascertainable fair market value in most cases. The value of a NQSO with a readily ascertainable fair market value at the time the option vests is determined by applying the rules set forth in Regs. §1.83-7(b). The value of a NQSO with an ascertainable fair market value (but not a readily ascertainable fair market value) at the time the option vests is determined under all the facts and circumstances in the particular case. Factors relevant to such a determination include, but are not limited to: (1) the difference between the option's exercise price and the value of the property subject to the option at the time of vesting; (2) the probability of the value of such property increasing or decreasing; and (3) the length of the period during which the option can be exercised. Prop. Regs. §1.280G-1, Q&A-13(a).

[142] Prop. Regs. §1.280G-1, Q&A-13(a) and 33.

[143] The proposed regulations offer no guidance as to how this recalculation should be made in the case of NQSOs. *See* ¶ 5720.03.C, *supra.*

[144] Prop. Regs. §1.280G-1, Q&A-13(b).

[145] §280G(b)(2)(C); Prop. Regs. §1.280G-1, Q&A-25.

[146] Prop. Regs. §1.280G-1, Q&A-26(a).

[147] Prop. Regs. §1.280G-1, Q&A-26(b).

[148] For these purposes, a nondiscriminatory employee plan or program is a group term life insurance plan that meets the requirements of §79(d); a self-insured medical reimbursement plan that meets the requirements of §105(h); a qualified group legal services plan within the meaning of §120; a cafeteria plan within the meaning of §125; an educational assistance program within the meaning of §127, or a dependent care assistance program within the meaning of §129. Prop. Regs. §1.280G-1, Q&A-26(c). It is not clear why a "nondiscriminatory

1044-7261/90/$0+.50

• a contract that replaces a prior contract entered into by the same parties more than one year before the change in ownership or control (if the new contract meets certain requirements);[149] or

• a contract between a corporation and a disqualified individual who did not perform services for the corporation prior to the individual's taxable year in which the change in ownership or control occurs (if the contract meets certain requirements).[150]

However, even if the one-year presumption is rebutted with respect to any agreement, payments under the agreement may still be contingent on the change in ownership or control pursuant to the general rules described in ¶ 5720.03.B, *supra*.[151]

Note: Due to this one-year presumption and the rules for rebutting such presumption, the reasons for any increase in compensation, amendments of employment contracts, or other actions with respect to compensation and/or benefits of disqualified individuals should be clearly documented. The better the contemporaneous documentation, the better the chance of overcoming the "one-year presumption."

Arguably, a payment should not be considered contingent on a change in control if actual payment was made prior to the change, even where such payment was made pursuant to a contract entered into within one year before such change. In the case of payments actually made prior to a change in ownership or control pursuant to a contract entered into within one year before such change, the irrevocable receipt of the payment prior to the change could arguably constitute "clear and convincing evidence" sufficient to rebut the presumption that such payment was contingent on a change of control. Thus, in order to preclude such benefits from being taken into account for purposes of the parachute payment rules, a corporation might, prior to a change of control and in contemplation of such change, vest non-vested benefits or accelerate their taxable receipt, especially if such benefits would vest or become payable on a change of control anyway. However, if such actions were taken by a corporation shortly before or coincident with a change of control, it might be difficult to establish that such payments were not contingent upon a change of control. Therefore, if this approach is utilized, it is advisable for a corporation to take this type of action as far in advance of a change of control as possible.[152]

▶ **Example**—*One-Year Presumption (1)*

A corporation and a disqualified individual who is an employee of the corporation enter into an employment contract replacing a prior contract entered into by the same parties more than 1-year before the change. The new contract does not provide for any increased payments other than a cost of living adjustment, does not accelerate the payment of amounts due at a future time, and does not modify (to the individual's benefit) the terms or conditions under which payments will be made. Clear and convincing evidence of these facts will rebut the 1-year presumption.[153]

▶ **Example**—*One-Year Presumption (2)*

Assume the same facts as in example (1), except that the contract is entered into after a tender offer for the corporation's stock has commenced, and at a time when it is likely that a change in ownership will occur, and the contract provides for a substantial bonus payment to the individual upon his signing the contract. The individual has performed services for the corporation for many years, but previous employment contracts between the corporation and the individual did not provide for a similar signing bonus. One month after the contract is entered into, a change in ownership of the corporation occurs. According to the proposed regulations, all payments under the contract are presumed to be contingent on the change in ownership even though the bonus payment would have been legally required even if no change had occurred. Clear and convincing evidence of the facts described, however, rebuts the 1-year presumption with respect to all of the payments under the contract with the exception of the bonus payment (which is treated as contingent on the change), even though actual payment of the signing bonus preceded the date of the change of control.[154]

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employee plan or program" is limited to these types of arrangements. Note that payments under certain qualified plans are exempt from the definition of a parachute payment pursuant to Prop. Regs. §1.280G-1, Q&A-8.

[149] *E.g.*, the new contract does not: (a) provide for increased payments (apart from normal increases attributable to increased responsibilities or cost of living adjustments); (b) accelerate the payment of amounts due at a future time; or (c) modify (to the individual's benefit) the terms or conditions under which payments will be made. Prop. Regs. §1.280G-1, Q&A-26(b)(2).

[150] *E.g.*, the contract does not provide for payments that are significantly different in amount, timing, terms or conditions from those provided under contracts entered into by the corporation (other than contracts that themselves were entered into within 1 year before the change in ownership or control and in contemplation of the change) with individuals performing comparable services. Prop. Regs. §1.280G-1, Q&A-26(b)(3).

[151] Prop. Regs. §1.280G-1, Q&A-26(b) (last sentence).

[152] *See Sullivan v. Easco Corp.*, 662 F. Supp. 1396 (D. Md. 1987) (Individual's receipt of benefits prior to a change in control, which can be retained even if a change in control never occurs, is the best evidence that a payment is not contingent on a change in control). Note that this case is inconsistent with Prop. Regs. §1.280G-1, Q&A-26(d) (Example 2).

[153] Prop. Regs. §1.280G-1, Q&A-26(d) (Example 1). Note, however, that the regulations indicate that payments under the contract could still be contingent on the change in ownership or control pursuant to Prop. Regs. §1.280G-1, Q&A-22.

[154] Prop. Regs. §1.280G-1, Q&A-26(d) (Example 2). As in example

¶ 5720.03.G
Exclusion for Payments from Qualified Plans

No payments from qualified plans [155] or simplified employee pension plans (SEPs) [156] will be parachute payments. [157] This exempts routine payments from these plans where the timing of the payment is accelerated by the change in control.

Note: The exemption also appears broad enough to cover pension parachutes, where a qualified pension plan has a provision to use up excess pension plan assets by increasing benefits to all employees across the board in the event of a change in control.

§5720.03.H
Exclusion for Reasonable Compensation for Future Services and Breach of Contract

Except for securities law violation parachute payments, the amount of a payment treated as a parachute payment does not include the portion of such payment which the taxpayer establishes by clear and convincing evidence to be reasonable compensation for personal services to be rendered on or after the change of ownership or control. [158] Thus, if a company's existing executives continue their employment with the company after the change and receive a new compensation package, and if that package is for services actually to be rendered, the present value of the payments under the new agreement will not be parachute payments.

Note: If the reasonableness standard is met as to the payments to be made under the new employment contract with the acquiring company (or the existing employment contract when the change occurred), such payments are not even included in the mathematical test for parachute payments. Thus, an employee with a base amount of $100,000 can enter into an employment contract for future services with the acquiring company which has a present value of $300,000 (or more) following a change of ownership or control (assuming no legal obligation on the part of the acquiring company to enter into such contract), [159] and assuming the existence of no other unanticipated parachute payments, can also receive a true parachute payment of $299,999 from the acquired company which will not be subject to the excise tax and for which the acquired employer will be able to take a deduction. Accordingly, the total payments to such employee which are arguably related to the change of ownership or control can be $599,999 (or more) without subjecting the employee to the excise tax and without resulting in a denial of the corporate deduction for any of such payments.

Generally, whether payments are reasonable compensation is determined on the basis of all the facts and circumstances in the particular case. Factors relevant to such a determination include the nature of the services rendered or to be rendered, the individual's historic compensation for performing such services, and the compensation of individuals performing comparable services in situations where the compensation is not contingent on the change. [160] A showing that payments are made under certain nondiscriminatory employee plans or programs will generally be considered to be clear and convincing evidence that the payments are reasonable compensation. This is true whether the personal services for which the payments are made are actually rendered before, or are to be rendered on or after, the date of the change in ownership or control. [161]

However, clear and convincing evidence of reasonable compensation for personal services to be rendered on or after the change in ownership or control will generally not exist if the individual does not, in fact, perform services for the company. Thus, payments pursuant to a consulting agreement or covenant not to compete, will not generally constitute reasonable compensation except to the extent that the executive actually performs such consulting services or to the extent it can be shown that it was substantially certain, at the time of the change of control, that such payments for covenants not to compete would have been made whether or not the change occurred. [162]

Accordingly, payments made or to be made to (or on behalf of) a disqualified individual for personal services to be rendered on or after the date of a change in ownership or control will generally be considered to be reasonable compensation for services to be rendered on or after the date of the change in ownership or control if (1) the payments were made or are to be made only for the period the individual actually performs personal services, and (2) the individual's annual compensation for such services is not significantly greater than such individual's annual compensation prior to the change in own-

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(1), the other payments under the contract could still be contingent on the change in ownership or control pursuant to Prop. Regs. §1.280G-1, Q&A-22. Note, also, that this is inconsistent with *Sullivan*, discussed in fn. 152, *supra*.

[155] Qualified plans described in §401(a) which include a trust exempt from tax under §501(a) or annuity plans described in §403(a). *See generally* ¶ 5500, *supra*.

[156] §408(k) plans. For a discussion of SEPs, *see* ¶ 5620, *supra*, and 355 T.M., *IRAs and SEPs*.

[157] Prop. Regs. §1.280G-1, Q&A-8.

[158] §280G(b)(4)(A); Prop. Regs. §1.280G-1, Q&A-9.

[159] Prop. Regs. §1.280G-1, Q&A-23.

[160] Prop. Regs. §1.280G-1, Q&A-40. *See also* ¶ 5420, *supra*, and 390 T.M., *Reasonable Compensation*.

[161] For this purpose, the nondiscriminatory employee plans or programs are the same as those described in fn. 148, *supra*. Prop. Regs. §1.280G-1, Q&A-26(b)(2) and (c) and Q&A-41.

[162] Note that in one place, the proposed regulations indicate that refraining from the performance of services (such as under a covenant not to compete or similar arrangement) constitutes the performance of services. *See* Prop. Regs. §1.280G-1, Q&A-11(a). For this purpose, however, the proposed regulations seem to require the actual performance of services. *See* Prop. Regs. §1.280G-1, Q&A-42(a).

1044-7261/90/$0+.50

ership or control, apart from normal increases attributable to increased responsibilities or cost of living adjustments (or is not significantly greater than the annual compensation customarily paid by the employer or by comparable employers to persons performing comparable services). [163]

An exception to the "actual performance of service" requirement provides that damages paid for the breach of an employment contract [164] may be reasonable compensation for services to be provided in the future, even though no services are actually provided, if certain factors are shown to exist. [165]

Thus, if the employment of a disqualified individual is involuntarily terminated before the end of a contract term and the individual is paid damages for the breach of the employment contract, a showing of the following factors generally is considered clear and convincing evidence that the payment is reasonable compensation for personal services to be rendered on or after the date of the change in control:

- The contract was not entered into, amended, or renewed in contemplation of the change in control;

Comment: This requirement is apparently intended to treat as parachute payments damages pursuant to double-trigger damage contracts (*i.e.*, ones requiring both a change of control and termination of employment to be triggered), and contracts where damages are greater where a termination of employment follows a change in control.

- The compensation the individual would have received under the contract would qualify as reasonable compensation;

- The damages do not exceed the present value (determined as of the date of receipt) of the compensation that the individual would have received under the contract if the individual had continued to perform services for the employer until the end of the contract term;

- The damages are received because an offer to provide personal services was made by the disqualified individual but was rejected by the employer; and

- The damages are reduced by mitigation. [166]

Damages are treated as mitigated if the damages are reduced (or any payment of such damages is returned) to the extent of the disqualified individual's earned income [167] during the remainder of the contract term ("pure dollar-for-dollar" mitigation). Note that this dollar-for-dollar mitigation technique is a safe harbor, and that other mitigation methods are contemplated by the proposed regulations, although no other methods are described therein. One issue concerning mitigation is whether the damages for breach of contract should be paid in full to the employee up front, or whether the damages should be paid to the employee through a rabbi trust or secular trust arrangement as the remaining term of the employment contract passes. The proposed regulations do not appear to require the spreading out of the damage payment over time as it would have been earned (presumably because such damage payment must be discounted to reflect its early payment), but they do require that such damages be equivalent to the present value of the lost wages. [168]

Severance payments are not treated as reasonable compensation for personal services actually rendered before, or to rendered on or after, the date of a change in control. Moreover, any damages paid for a failure to make severance payments are not treated as reasonable compensation for personal services actually rendered before, or to be rendered on or after, the date of such a change in control. For this purpose, the term "severance payment" includes any payment that is made to (or for the benefit of) a disqualified individual on account of the termination of such individual's employment prior to the end of a contract term, but does not include any payment that otherwise would be made to (or for the benefit of) such individual upon the termination of such individual's employment, whenever occurring. [169] Thus, it appears

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[163] Prop. Regs. §1.280G-1, Q&A-40, Q&A-26(b)(3), and Q&A-42(a)(2) and (b)(3).

[164] Note, however, that such damages cannot be attributable to the failure to make severance payments. *See* Prop. Regs §1.2.80G-1, Q&A-44.

[165] Prop. Regs. §1.280G-1, Q&A-42(b).

[166] Prop. Regs. §1.280G-1, Q&A-42(b)(5).

[167] Within the meaning of §911(d)(2)(A). It should be noted that this definition apparently excludes deferred compensation. Section 911(d)(2)(A) defines earned income as wages, salaries, or professional fees, and other amounts received as compensation for services actually rendered. Arguably, such deferred compensation must be received after the close of the first taxable year following the taxable year in which the service giving rise to the amounts were performed for it to be excluded from the concept of earned income for mitigation purposes. *See* §911(b)(1)(B)(iv) and Regs. §1.911-3(c)(6). However, Prop. Regs. §1.280G-1, Q&A-42(b)(5) refers to mitigations to the extent of earned income during the remainder of the period in which the contract would have been in effect, presumably based on the disqualified individual's cash basis of accounting. Moreover, the purpose of §911(b)(1)(B)(iv) [formerly §911(c)(4)] was to reflect Congressional intent that an exclusion from income for deferred compensation payments was not necessary to achieve the objectives of §911. *See Johnson v. Comr.*, 36 T.C.M. 1531 (1977).

Although the necessity of the §911(b)(1)(B)(iv) exclusion of certain deferred amounts from the definition of foreign earned income suggests that earned income otherwise includes deferred compensation (no matter when received), this exclusion is only necessitated by the attribution rule [attributing earned income to the year in which services are performed, rather than the year in which such earned income is received, for purposes of calculating the foreign earned income exclusion] of §911(b)(2)(B). Accordingly, neither §911(b)(1)(B)(iv) nor the attribution rule should be applicable to the breach of contract requirement under Prop. Regs. §1.280G-1, Q&A-42(b)(5). *See Groetzinger v. Comr.*, 87 T.C. 533, 546 (1986) (Attribution rule in effect puts a cash basis taxpayer on the accrual method of accounting exclusively for the purpose of calculating the §911 exclusion).

[168] *See* Prop. Regs. §1.280G-1, Q&A-42(b)(3).

[169] Prop. Regs. §1.280G-1, Q&A-44.

that a non-contractual severance pay arrangement (especially a service-based severance pay arrangement) where all terminated employees (whether voluntary or involuntary terminations) receive a certain percentage of pay when their employment terminates, should be considered reasonable compensation for services previously rendered. [170]

▶ **Example**—*Compensation for Future Services (1)*

Disqualified individual A has a 3-year employment contract with publicly traded Corporation M. Under this contract, A is to receive a salary of $100,000 for the first year of the contract, and for each succeeding year, an annual salary that is 10% higher than his prior year's salary. During the third year of the contract, Corporation N acquires all of M's stock. Prior to the change in ownership, N arranges to retain A's services by entering into an employment contract with him that is essentially the same as A's contract with M. Under the new contract, N is to fulfill M's obligations for the third year of the old contract, and for each of the succeeding years, is to pay A an annual salary that is 10% higher than his prior year's salary. Amounts are payable under the new contract only for the portion of the contract term during which A remains employed by N. In the absence of contradictory evidence, these facts demonstrate clear and convincing evidence that all payments under the new contract are reasonable compensation for personal services to be rendered on or after the date of the change in control and are not parachute payments. [171]

▶ **Example**—*Compensation for Future Services (2)*

Assume the same facts as in the preceding example, except that the employment contract with N does not provide that amounts are payable under the contract only for the portion of the term for which A remains employed by N. Shortly after the change in ownership, and despite A's request to remain employed by N, A's employment with N is involuntarily terminated, and shortly thereafter, A obtains employment with Corporation O. A sues N for breach of her employment contract. In settlement of the litigation, A receives an amount equal to the present value of the compensation she would have received under the contract with N, reduced by the amount of compensation A otherwise receives from O during the period that the contract would have been in effect. This showing (in the absence of contradictory evidence) is regarded as clear and convincing evidence that the amount A received as damages is reasonable compensation for personal services to be rendered on or after the date of the change in ownership or control, and is not a parachute payment. [172]

¶ 5720.03.I
Exclusion for Payments by Corporations Whose Stock Is Not Readily Tradable

Payments made to disqualified individuals by S corporations [173] are not considered parachute payments. [174] There is also an exclusion for payments by certain C corporations whose stock is not readily tradable on an established securities market, provided that certain shareholder approval requirements are satisfied. [175]

The C corporation shareholder approval requirement is satisfied with respect to any payment if:

- the payments are approved by a separate vote of the persons who owned, immediately before the change in control, more than 75% of the voting power of all outstanding stock of the corporation; and
- adequate disclosure is made (to all persons entitled to vote for such approval) of the material facts concerning all material payments which would be parachute payments but for this exception. [176]

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[170] Alternatively, a severance payment with respect to an individual employee should also be considered reasonable compensation for services previously rendered if such payment would have been made upon an involuntary or voluntary termination of employment, whenever occurring.

[171] Prop. Regs. §1.280G-1, Q&A-42(c) (Example 1).

[172] Prop. Regs. §1.280G-1, Q&A-42(c) (Example 2).

[173] As defined in §1361(b), but without regard to §1361(b)(1)(C), which prohibits nonresident alien shareholders. Note that it does not matter that the S Corporation is a member of an affiliated group which also includes C Corporations. *See* Prop. Regs. §1.280G-1, Q&A-6(b).

[174] §280G(b)(5)(A)(i); Prop. Regs. §1.280G-1, Q&A-6(a)(1).

[175] §280G(b)(5)(A)(ii); Prop. Regs. §1.280G-1, Q&A-6(a)(2). Prop. Regs. §1.280G-1, Q&A-6(c), specifically indicates that this exclusion does not apply if any stock of any member of the affiliated group (as described in Prop. Regs. §1.280G-1, Q&A-46) is readily tradable. *Cf.* Prop. Regs. §1.280G-1, Q&A-6(b), which treats the members of an affiliated group that includes an S corporaton, but apparently not the members of an affiliated group that includes a C corporation whose stock is not readily tradable, as separate corporations for purposes of this exclusion from parachute payment status. The reason for this distinction is to clarify that an affiliated corporate shareholder of an S corporation would be separate from the S corporation and, therefore, a prohibited corporate shareholder of such S corporation. §1361(b)(1)(B). Nevertheless, the unavailability of this exclusion from parachute payment status for C corporations where any affiliated C corporation has readily tradable stock seems to go beyond the intent of the legislative history in certain cases. For example, if a division of a privately held holding company which also holds stock in certain public companies enters into an employment contract with some of the officers of that division, this exclusion should be available since such a scenario cannot be created pursuant to a reorganization in an effort to avoid golden parachute implications.

[176] Prop. Regs. §1.280G-1, Q&A-7(a). To satisfy this requirement, disclosure must be full and truthful disclosure of the material facts and such additional information as is necessary to make the disclosure not materially misleading at the time the disclosure was made. An omitted fact is considered a material fact if there is a substantial likelihood that a reasonable shareholder would consider it important. Prop. Regs. §1.280G-1, Q&A-7(d).

1044-7261/90/$0+.50

The vote described above must determine the right of the disqualified individual to receive the payment, or in the case of a payment made before the vote, the right of the disqualified individual to retain the payment. [177]

Approval of a payment by any shareholder that is not an individual ("entity shareholder") generally must be made by the person authorized by the entity shareholder to approve the payment. However, if a substantial portion of the assets of an entity shareholder consists (directly or indirectly) of stock in the corporation undergoing the change in ownership or control, approval of the payment by that entity shareholder must be made by a separate vote of the persons who hold, immediately before the change in ownership or control, more than 75% of the voting power of the entity shareholder. This special requirement regarding entity shareholder approval does not, however, apply if the value of the stock of the C corporation owned, directly or indirectly, by or for the entity shareholder does not exceed 1% of the total value of the outstanding stock of such C corporation. Where approval of a payment by an entity shareholder must be made by a separate vote of the owners of the entity shareholder, the normal voting rights of the entity shareholder determine which owners may vote. [178]

When determining the persons who own more than 75% of the voting power of a corporation's outstanding stock for purposes of this shareholder approval requirement, stock is not counted as outstanding stock if the stock is actually or constructively owned [179] by or for a disqualified individual who receives (or is to receive) payments that would be parachute payments if the shareholder approval requirements were not met. Similarly, stock is not counted as outstanding stock if the owner is considered [180] as owning any part of the stock owned directly or indirectly by or for the disqualified individual who is to receive such payments. However, if all persons who hold voting power in the corporation or the entity shareholder are disqualified individuals or related persons, then stock owned by all such persons is counted as outstanding stock for purposes of the shareholder approval requirement. [181]

For purposes of the exception with respect to payments by C corporations, stock is treated as readily tradable if it is regularly quoted by brokers or dealers making a market in such stock. [182] However, a company fails to meet the no readily tradable stock requirement if a substantial portion of the assets of any entity consists of stock in the corporation purported to have no readily tradable stock, and interests in such entity shareholder are readily tradable on an established securities market or otherwise. For this purpose, such stock constitutes a substantial portion of the assets of an entity shareholder if the total fair market value of the stock is equal to or more than one-third of the total fair market value of all of the assets of the entity. [183] The purpose of this rule, which is supported by the legislative history, is to prevent a company from taking improper advantage of the shareholder vote rule by, *e.g.*, creating tiers of entities, such as holding companies. [184]

¶ 5720.03.J
Exclusion for Payments Pursuant to Grandfathered Parachute Agreements

In general, the golden parachute provisions apply to payments under agreements entered into or renewed after June 14, 1984. For this purpose, any agreement that is entered into before June 15, 1984, and is renewed after June 14, 1984, is treated as a new contract entered into on the day the renewal takes effect. [185] Thus, the golden parachute provisions do not apply to parachute payments that are made under agreements entered into before June 15, 1984, that are not renewed, amended or supplemented in any significant relevant respect after June 14, 1984. [186] A "supplement" to a contract means a new contract entered into after June 14, 1984, that affects the trigger, amount, or time of receipt of a payment under an existing contract. [187]

A contract is considered to be "amended or supplemented in significant relevant respect" if provisions for payments contingent on a change in control ("parachute provisions") are added to the contract or are amended or supplemented to provide significant additional benefits to the disqualified individual. Thus, for example, a contract generally is treated as "amended or supplemented in significant relevant respect" if it is amended or supplemented:

- to add or modify (to the disqualified individual's benefit) a change in control trigger to an existing agreement;

- to increase amounts payable that are contingent on a change in control (or, where payment is to be made under a formula, to modify the formula to the disqualified individual's advantage); or

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[177] Prop. Regs. §1.280G-1, Q&A-7(a)(2). **Note:** The proposed regulations appear to be changing corporate law by suggesting that this tax law vote control the right to retain golden parachute payments. Certainly that is not the intent.

[178] Prop. Regs. §1.280G-1, Q&A-7(b).

[179] Under §318(a).

[180] *Id.*

[181] Prop. Regs. §1.280G-1, Q&A-7(c).

[182] Prop. Reg. §1.280G-1, Q&A-6(e). For this purpose, certain preferred stock which is described in §1504(a)(4) is not treated as being readily tradable on an established securities market if the payment does not adversely affect the shareholder's redemption and liquidation rights. Prop. Regs. §1.280G-1, Q&A-6(d). Pursuant to Prop. Regs. §1.280G-1, Q&A-6(f), an established securities market is one as defined in Regs. §1.897-1(m).

[183] Prop. Regs. §1.280G-1, Q&A-6(c).

[184] *See* Prop. Regs. §1.280G-1, Q&A-6(g) (Example 3).

[185] Prop. Regs. §1.280G-1, Q&A-4 and Q&A-47.

[186] Prop. Regs. §1.280G-1, Q&A-4 and Q&A-49.

[187] Prop. Regs. §1.280G-1, Q&A-49.

• to accelerate (in the event of a change in control) the payment of amounts otherwise payable at a later date.

For this purpose, a payment is not treated as being accelerated in the event of a change in ownership or control if the acceleration does not increase the present value of the payment. [188]

Not all changes to compensation arrangements are treated as significant for this purpose. For instance, if a nonqualified stock bonus plan is amended to prevent the forfeiture of previously granted, but unvested, shares in the event of termination of the plan following a merger, consolidation or sale (*e.g.*, by continuing vesting of previously granted shares as if the plan had not been terminated), such an amendment should not be treated as amending the plan in a significant relevant respect, provided that the plan participants are not already entitled to any grandfathered parachute benefits that have the effect of compensating them for the possible forfeiture of shares in the event of a merger, consolidation or sale of the corporation. [189] However, the grant after June 14, 1984 of a stock option under a plan approved before June 15, 1984 is *not* grandfathered even though the terms of the plan that contained the change-in-control feature and that authorized the grant of the stock options were approved prior to June 15, 1984. [190]

A change in the enforcement mechanism for a parachute agreement whereby the payor corporation agrees to pay legal fees of the executive in any enforcement action where the disqualified individual prevails should not cause the loss of grandfather protection, since legal fees paid in connection with the payment of potential parachute payments are not payments in the nature of compensation. [191]

Note: The proposed regulations seem to focus on the receipt by the disqualified individual of significant additional benefits and/or increased payments (in present value terms). Thus, actions that include no increase in payments and no acceleration of payment but merely provide greater protection, such as the establishment of a trust or suretyship, should not cause the loss of grandfather protection.

For purposes of determining whether the golden parachute provisions apply to a particular agreement, a contract that is terminable or cancellable unconditionally at will by either party to the contract without the consent of the other, or by both parties to the contract, is treated as a new contract entered into on the date any such termination or cancellation, if made, would be effective. However, a contract is not treated as terminable or cancellable if it can be terminated or cancelled only by terminating the underlying employment relationship or independent contractor relationship of the disqualified individual. [192] Contracts may not be treated as amended or supplemented for purposes of the grandfather rule merely by reason of normal adjustments in terms of the employment relationship. Whether an adjustment in the terms of the employment relationship is considered normal for this purpose depends on all of the facts and circumstances of the particular case. Relevant factors include, but are not limited to:

• the length of time between the adjustment and the change in control;

• the extent to which the corporation viewed itself as a likely takeover candidate at the time of the adjustment;

• a comparison of the adjustment with historical practices of the corporation;

• the extent of overlap between the group receiving the benefits of the adjustment and those members of that group who are the beneficiaries of grandfathered pre-June 15, 1984 parachute contracts; and

• the size of the adjustment (in absolute terms and in comparison with the benefits provided to other members of the group receiving the benefits of the adjustment). [193]

For example, a normal adjustment in compensation that results in an increase of parachute payments proportional to compensation will be protected under the grandfather provision. Moreover, an amendment to a currently exercisable stock option to permit the employee to surrender it for cash is not a change that will result in the loss of grandfather status.

Note: The risk of destroying any grandfathered parachute payment protection with respect to existing benefits should be analyzed prior to granting to any disqualified individual who is entitled to grandfather "parachute-type" benefits any new benefits which are contingent on a change of control.

▶ **Example**—*Grandfathered Parachute Payments (1)*

Corporation M granted a nonqualified stock option to a disqualified individual before June 15, 1984. After June 14, 1984, at a time when the option is currently vested and exercisable by the individual, M amends the option to permit the individual to surrender it for cash or other property equal to the fair market value of the stock that would have been received if the option had been exercised (minus the exercise price of the option). Since the individual could have exercised the option and then sold the stock received upon the exercise, the amendment does not provide significant

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[188] Prop. Regs. §1.280G-1, Q&A-50.

[189] S. Rep. No. 313, 99th Cong., 2d Sess. 921 (1986). *See also* Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess., *Explanation of Technical Corrections to the Tax Reform Act of 1984 and Other Recent Tax Legislation*, p. 34.

[190] DEFRA Blue Book at 206.

[191] Prop. Regs. §1.280G-1, Q&A-11.

[192] Prop. Regs. §1.280G-1, Q&A-48.

[193] Prop. Regs. §1.280G-1, Q&A-51.

1044-7261/90/$0+.50

additional benefits to the individual. Therefore, the amendment does not cause payments under the option to lose their grandfather status. [194]

▶ **Example**—*Grandfathered Parachute Payments (2)*

Corporation N and disqualified individual A entered into an employment contract before June 15, 1984 that provides for a payment, contingent on a change in the ownership or control of N, equal to 4 times A's base amount. After June 14, 1984, and at a time when N did not view itself as a likely takeover candidate, N increased A's annual compensation by 25% to reflect additional managerial responsibilities. Such increase is consistent with the historical practices of N. Although the amount payable to A contingent on a change in ownership of N increased as a result of A's increased compensation, the employment contract is not treated as amended in significant relevant respect because (and in the absence of contrary evidence) the amendment to the contract is treated as a normal adjustment in the terms of the employment relationship. [195]

▶ **Example**—*Grandfathered Parachute Payments (3)*

Before June 15, 1984, Corporation O entered into contracts with disqualified individuals A, B, and C, providing for payments to them, contingent on a change in the ownership of O, equal to 4 times each such individual's base amount. After June 14, 1984, O, consistent with its historical practices, grants identical nonvested stock options to numerous disqualified individuals including A, B, and C. All of these new options provide that the vesting of all such options will be accelerated if a change in control of O occurs. Although the golden parachute provisions apply to payments under the options granted after June 14, 1984, the granting of these options does not cause the contracts that were entered into before June 15, 1984 to be treated as amended or supplemented in significant relevant respect because (and in the absence of contrary evidence) the granting of options is treated as a normal adjustment in the terms of the employment relationship. [196]

¶ 5720.04
Securities Violation Parachute Payments

In addition to parachute payments determined pursuant to the mathematical test discussed *supra*, parachute payments also include any payment in the nature of compensation to or for the benefit of a disqualified individual if such payment is made, in connection with a potential or actual change in ownership or control, pursuant to an agreement that violates any generally enforced federal or state securities laws or regulations. [197] The three-times-base-amount safe harbor and the rules relating to reasonable compensation generally have no application with respect to securities violation parachute payments if such payments are not also mathematical test parachute payments (*e.g.*, contingnet upon the change in control). [198] The IRS generally bears the burden of proof on the issue of whether a securities violation has occurred. [199]

Although securities violation parachute payments need not be contingent on a change in control to be parachute payments, special rules apply for securities violation parachute payments that are also contingent upon the change in control. Securities violation parachute payments that are *not* contingent on a change in ownership or control [200] are not taken into account in applying the three-times-base-amount mathematical test under any circumstances. Such payments are considered parachute payments regardless of whether the three-times-base-amount threshold is exceeded with respect to the disqualified individual. Moreover, the amount of such payments that are treated as excess parachute payments is not reduced by the portion of such payment that is reasonable compensation for personal services actually rendered before the date of the change in control. Finally, the amount of such payments includes the portion of such payment that is reasonable compensation for personal services to be rendered on or after the date of a change in control. [201] These same rules also apply to securities violation parachute payments that *are* contingent on a change of control, but only if the application of these rules results in greater total excess parachute payments with respect to the disqualified individual than would result if the payments were treated simply as payments contingent on such change of control. [202]

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[194] Prop. Regs. §1.280G-1, Q&A-52 (Example 1).

[195] *Id.* (Example 2).

[196] *Id.* (Example 3). Query whether the granting of additional parachute payments to a disqualified individual who is entitled to receive payments pursuant to a grandfathered parachute agreement jeopardizes the grandfathered status of the existing agreements.

[197] §280G(b)(2)(B); Prop. Regs. §1.280G-1, Q&A-37. Some payments which are contingent on a change in control (such as gross-up payment to reimburse disqualified individuals for the excise taxes they may be forced to pay under the golden parachute provisions) may eventually be challenged by shareholders as violating state or federal securities laws (*e.g.*, as contrary to the excise tax penalty imposed by the golden parachute provisions, or contrary to public policy, or corporate waste). If such a challenge is successful, such gross-up payments would constitute securities violation parachute payments, and none of those amounts would be reasonable compensation for services previously rendered.

[198] Prop. Regs. §1.280-G, Q&A-9, Q&A-37 and Q&A-39.

[199] §280G(b)(2)(B).

[200] Within the meaning of Prop. Regs. §1.280G-1, Q&A-22.

[201] Prop. Regs. §1.280G-1, Q&A-37(b).

[202] Prop. Regs. §1.280G-1, Q&A-37(c).

▶ **Example**—*Securities Violation Parachute Payments (1)*

A, who is a disqualified individual with respect to Corporation M, receives 2 payments in the nature of compensation that are contingent on a change in control of M. The present value of the first payment is equal to A's base amount and is not a securities violation parachute payment. The present value of the second payment is equal to 1.5 times A's base amount and is a securities violation parachute payment. Neither payment includes any reasonable compensation. If the second payment is treated simply as a payment contingent on a change in control, the amount of A's total excess parachute payments is zero, because the aggregate present value of the payments does not equal or exceed 3 times A's base amount. However, if the second payment is treated as a securities violation parachute payment, the amount of A's total excess parachute payments is 0.5 times A's base amount. Thus, the second payment is treated as a securities violation parachute payment [203]

▶ **Example**—*Securities Violation Parachute Payments (2)*

Assume the same facts as in example (1), except that the present value of the first payment is equal to 2 times A's base amount. If the second payment is treated simply as a payment contingent on a change in control and is subjected to the 3-times-base-amount mathematical test, the total present value of the payments is 3.5 times A's base amount, and the amount of A's total excess parachute payments is 2.5 times A's base amount. If the second payment is treated as a securities violation parachute payment, however, the amount of A's total excess parachute payments is only 0.5 times A's base amount. Thus, the second payment is treated simply as a payment contingent on a change in control. [204]

▶ **Example**—*Securities Violation Parachute Payments (3)*

B, who is a disqualified individual with respect to Corporation N, receives 2 payments in the nature of compensation that are contingent on a change in control of N. The present value of the first payment is equal to 4 times B's base amount and is a securities violation parachute payment. The present value of the second payment is equal to 2 times B's base amount and is not a securities violation parachute payment. B establishes by clear and convincing evidence that the entire amount of the first payment is reasonable compensation for personal services to be rendered after the change in control. If the first payment is treated simply as a payment contingent on a change in control, it is exempt from the definition of a parachute payment. [205] Thus, the amount of B's total excess parachute payment is zero because the present value of the second payment does not equal or exceed 3 times B's base amount. However, if the first payment is treated as a securities violation parachute payment, the amount of B's total excess parachute payments is 3 times B's base amount (the total securities violation parachute payment less the base amount). Thus, the first payment is treated as a securities violation parachute payment [206]

▶ **Example**—*Securities Violation Parachute Payments (4)*

Assume the same facts as in example (3), except that B does not receive the second payment, and B establishes by clear and convincing evidence that the entire amount of the first payment is reasonable compensation for services actually rendered before the change in control of N. If the first payment is treated simply as a payment contingent on a change in control, the amount of B's excess parachute payment is zero, because the amount treated as an excess parachute payment is reduced by the amount that B establishes to be reasonable compensation for services previously rendered. However, if the first payment is treated as a securities violation parachute payment, the amount of B's excess parachute payment is 3 times B's base amount since securities violation parachute payments are not reduced by reasonable compensation for services previously rendered. Thus, the payment is treated as a securities violation parachute payment. [207]

¶ 5720.05
Calculating the Excess Parachute Amount

The amount of *excess* parachute payments with respect to any disqualified individual is equal to the total parachute payments to him, determined pursuant to the mathematical and securities violation parachute payment tests described above, reduced by the greater of:

- except in the case of securities violation parachute payments, the portion of each such payment which constitutes reasonable compensation for services previously rendered; and
- the applicable portion of the base amount allocable to such payment.

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[203] Prop. Regs. §1.280G-1, Q&A-37(d) (Example 1).

[204] *Id.* (Example 2).

[205] Prop. Regs. §1.280G-1, Q&A-9.

[206] Prop. Regs. §1.280G-1, Q&A-37(d) (Example 3).

[207] *Id.* (Example 4).

1044-7261/90/$0+.50

¶ 5720.05.A
Reasonable Compensation for Services Previously Rendered

Except in the case of securities violation parachute payments, the amount of a payment treated as an *excess* parachute payment, and thus potentially subject to the golden parachute penalty provisions, is reduced by any portion of the payment that a taxpayer establishes, by clear and convincing evidence, to be reasonable compensation for personal services actually rendered by the disqualified individual before the date of change in ownership or control. [208] When determining whether mathematical test parachute payments constitute reasonable compensation for services previously rendered, services that are reasonably compensated for by payments that are not contingent on a change in control and are not securities violation parachute payments (or payments made pursuant to a contract entered into before June 15, 1984, that has not been renewed, or amended or supplemented in significant relevant respect after June 14, 1984) are not taken into account as services rendered. Payments generally should be considered reasonable compensation for services previously rendered if such payments qualify as reasonable compensation under the normal deduction rules. [209] Thus, in order to eliminate all *excess* parachute payments where a parachute payment situation exists, the disqualified individual must show that all of the parachute payments represent reasonable compensation for services previously rendered. However, an amount cannot generally be supported as reasonable compensation for services previously rendered simply by arguing that the executive was undercompensated in years prior to the change in control. [210]

Types of payments which constitute reasonable compensation for services previously rendered include:

- payments in cancellation of normal stock options, or normal stock appreciation rights, which were granted more than one year before the change;
- exercises after termination of stock options or stock appreciation rights issued as part of a normal compensation package granted more than one year before the change;
- compensation previously earned and deferred, either at the election of the employee or pursuant to a plan of the employer (such as a staggered bonus plan); and
- amounts paid under a retirement plan that supplements a tax-qualified plan, to the extent such amounts compensate a newly hired key employee for the loss of retirement benefits attributable to prior employment with competitors. [211]

Comment: Shareholder approval of a compensation agreement is arguably "per se" proof that the compensation constitutes reasonable compensation for past services. [212]

As discussed *infra*, amounts that are established by clear and convincing evidence to be reasonable compensation for services previously rendered are first applied against the base amount allocable to such payments (which would not have been subject to the tax penalties in any event). [213] Thus, by establishing that an amount is reasonable compensation for past services, an executive will not necessarily reduce the amount of *excess* parachute payments (*i.e.*, amounts subject to the parachute tax penalties). The employee can reduce the amount of excess parachute payments only by establishing that an amount in excess of his or her base amount that is allocable to the payment at issue constitutes reasonable compensation for services previously rendered. Moreover, even if a payment constitutes reasonable compensation in its entirety, such payment can still give rise to parachute consequences.

▶ **Example**—*Reasonable Compensation for Services Previously Rendered (1)*

Parachute payments of $599,999 are made to A, a disqualified individual whose base amount is $100,000. Assume that $300,000 of these parachute payments are benefits under an option exercised upon the change in control that are proven to be reasonable compensation for services rendered prior to the change, and that $299,999 of these parachute payments are pure termination agreement payments. The initial conclusion might be that because the pure parachute payment (termination agreement payment) is less than $300,000 (3 times the base amount), and because the other parachute payment is reasonable compensation for past services in its entirety, A would have no excess parachute payments. However, parachute payments that constitute reasonable compensation for past services are counted for purposes of determining whether the $299,999 safe harbor is exceeded, and only $300,000 of the $599,999 of total parachute payments is proven to be reasonable compensation for past services. Therefore, the entire $299,999 of pure parachute payment is taxable as an excess parachute payment since the excess parachute payments of

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[208] §280G(b)(4)(B).

[209] Prop. Regs. §1.280G-1, Q&A-43; *see* §162 and the discussion thereof at ¶ 2130, *supra*.

[210] In the legislative history of DEFRA, Congress stated its belief that executives in large, publicly held corporations are not undercompensated and that "only in rare cases" will the facts show that an executive was under-compensated for periods prior to the change in control. H. Conf. Rep. No. 861, 98th Cong., 2d Sess. II-852 (1984).

[211] *Id.*

[212] Payments are generally considered reasonable if they qualify as reasonable compensation under §162. *See* Prop. Regs. §1.280G-1, Q&A-43. Since payments of compensation by publicly held corporations have seldom, if ever, been challenged as unreasonable, most compensation by publicly held corporations in contemplation of a change in control should be found to be reasonable compensation.

[213] §280G(b)(3) and (4); Prop. Regs. §1.280G-1, Q&A-38.

$499,999 ($599,999 - $100,000) are only reduced by $200,000 (the extent to which $300,000 exceeds the base amount of $100,000).

▶ **Example**—*Reasonable Compensation for Services Previously Rendered (2)*

Assume that a parachute payment of $600,000 is made to a disqualified individual, and the portion of such individual's base amount allocated to such parachute payment is $100,000. Assume that $300,000 of the $600,000 parachute payment is established by clear and convincing evidence to be reasonable compensation for personal services actually rendered by the disqualified individual before the date of the change in control. Before the reasonable compensation is taken into account, the amount of the excess parachute payment is $500,000 ($600,000 - $100,000). When reducing the excess parachute payment by reasonable compensation for past services, the portion of the parachute payment that is established as reasonable compensation ($300,000) is first reduced by the portion of the disqualified individual's base amount that is allocated to the parachute payment ($100,000), and the remainder ($200,000) then reduces the excess parachute payment. Thus, in this case, the excess parachute payment of $500,000 is reduced to $300,000. If the full amount of the $600,000 parachute payment is established by clear and convincing evidence to be reasonable compensation for personal services actually rendered by the disqualified individual before the date of the change in ownership or control, the excess parachute payment of $500,000 can be reduced to zero. In that case, no portion of any deduction for such payments would be disallowed, and no portion of such payments would be subject to the 20% excise tax. [214]

Where an excess parachute payment is received over a number of years, reasonable compensation in excess of the base amount allocable to such excess parachute payment is to be allocated to the first payment made (and not to all such payments on a pro rata basis). [215]

Comment: To take advantage of the exclusion from excess parachute payment status of reasonable compensation for past services, an employer could provide a supplemental retirement plan (SERP) under which benefits are ratably earned during employment but do not vest until age 65. However, upon a change in control in such a case, an employee could lose his entire unvested SERP benefit if the acquiring company so decided. Thus, to protect against this, the SERP could provide for accelerated vesting of all SERP benefits (or only the earned SERP benefits) upon a change in control, in which case the SERP benefits earned and attributable to prior service would be parachute payments but would also be compensation for services previously rendered. Such amounts would count when determining whether the three-times-base-amount threshold had been exceeded, but such amounts would also reduce the amount subject to tax to the extent that they are "reasonable" compensation and to the extent that they exceed the base amount allocable to the SERP benefits. In fact, pure termination agreement payments could be converted into SERP-type benefits in order to reduce overall parachute payment consequences. If all pure termination agreement payments are so converted, and all other payments to the disqualified individual constitute reasonable compensation for services previously rendered, parachute payment consequences can, potentially, be totally eliminated. [216] Moreover, if such SERP benefits are vested as they are earned, they are completely removed from the status of parachute payments except to the extent of any increased value attributable to the accelerated payment of such vested benefits upon a change of control. In the latter case, however, the executive would also be entitled to such vested benefits if he terminated employment prior to age 65 for reasons other than a change of control. For additional discussion of SERPs, *see* ¶ 5710.02.I.1, *supra*. For a discussion of the treatment of severance pay as reasonable compensation for services previously rendered, *see* ¶ 5720.03.H, *supra*.

¶ 5720.05.B
Applicable Portion of Base Amount Attributable to Parachute Payments

Only *excess* parachute payments are subject to the golden parachute penalty provisions. [217] The term "excess parachute payment" means an amount equal to the excess of any parachute payment over the portion of the disqualified individual's base amount allocated to such payment. [218] When determining the amount of excess parachute payments, the most difficult task can be determining the base amount allocable to each payment.

The base amount must be allocated on a present-value basis across the stream of parachute payments, so that the portion of the base amount allocated to any parachute payment is the amount that bears the same ratio to the total base amount as the present value of such parachute payment bears to the aggregate present value of all parachute payments made or to be made to

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[214] Prop. Regs. §1.280G-1, Q&A-39(c) (Examples 1 and 2).

[215] H. Conf. Rep. No. 861, 98th Cong., 2d Sess. at II-853.

[216] Legislative history indicates that payments of compensation previously earned are to be treated as reasonable compensation. *See* H. Conf. Rep. No. 861, 98th Cong., 2d Sess. II-852 (1984); DEFRA Blue Book at 204; Tech. Corr. Bluebook at 29. This may mean, therefore, that the value of accelerated vesting of the SERP benefits described above will not be treated as compensation for services previously rendered to the extent that the receipt of any benefit where vesting was accelerated required the performance of additional services. *See* Prop. Regs. §1.280G-1, Q&A-24.

[217] §§280G(a) and 4999(a).

[218] §280G(b)(1).

1044-7261/90/$0+.50

(or for the benefit of) the same disqualified individual.[219] Thus, the portion of the base amount allocated to any parachute payment is determined by multiplying the base amount by a fraction, the numerator of which is the present value of such parachute payment and the denominator of which is the aggregate present value of all such payments.[220]

▶ **Example**—*Allocation of Base Amount (1)*

A disqualified individual with a base amount of $100,000 is entitled to receive 2 parachute payments, one for $200,000 and one for $400,000. The $200,000 payment is made at the time of the change in control, and the $400,000 payment is to be made at a future date. The present value of the $400,000 payment is $300,000 on the date of the change in control. The portions of the base amount allocated to these payments are $40,000 ($200,000/$500,000 × $100,000) and $60,000 ($300,000/$500,000 × $100,000), respectively. Thus, the amount of the first payment that constitutes an excess parachute payment is $160,000 ($200,000 - $40,000) and the amount of the second payment which constitutes an excess parachute payment is $340,000 ($400,000 - $60,000).[221]

▶ **Example**—*Allocation of Base Amount (2)*

X, a disqualified individual with a base of $100,000, is entitled to receive a 5-year steam of parachute payments having a present value on the date of the change of control of $500,000. In 1989, X receives parachute payments of $200,000 (with the same present value). The portion of X's base amount allocated to the $200,000 parachute payments received in 1989 is $40,000 ($100,000 × $200,000/$500,000). Thus, of the $200,000 received in 1989, $160,000 would be excess parachute payments.

Once the base amount allocable to each parachute payment and the resulting excess parachute payments have been determined, the portion of the excess parachute payments that constitutes reasonable compensation for services rendered before the change in control, if any, must be applied against the base amount.[222] To the extent such reasonable compensation exceeds the base amount, it should be applied against the first excess parachute payments made.[223]

▶ **Example**—*Allocation of Base Amount (3)*

In example (2), *supra*, assume that $250,000 of the parachute payments paid to X are shown by clear and convincing evidence to constitute reasonable compensation for services rendered before the change in control. Such reasonable compensation would first be offset against the base amount ($100,000). The remaining $150,000 of reasonable compensation ($250,000 - $100,000) would be applied against the first parachute payments made. Thus, X would have $10,000 ($160,000 - $150,000) of excess parachute payments subject to excise tax in 1989. Furthermore, excess parachute payments received by X in subsequent years would not be reduced by reasonable compensation since all such reasonable compensation would have been used in the first year.

¶ 5720.06
Tax Consequences of Parachute Payments

¶ 5720.06.A
Excise Tax on Payee

A 20% nondeductible excise tax is imposed on the recipient of an excess parachute payment.[224]

Accordingly, the excise tax is imposed on the excess of the parachute payments over the base amount, rather than the excess of such parachute payments over the safe harbor of 2.99 times the base amount. This excise tax, combined with the payor corporation's loss of its deduction, causes a parachute payment that exceeds 299% of the base amount by only a single dollar to be very costly to the corporation, and to yield a much smaller after-tax benefit to the executive. In 1989 and 1990, for example, a parachute payment of 376.9% of the base amount provides the same benefit to the executive as, but cost the corporation 72% more than, a payment of 299% of the base amount.[225] The excise tax is imposed only when a parachute payment is actually paid and the tax is subject to withholding by the payor corporation.[226]

¶ 5720.06.B
Loss of Corporate Deduction for Excess Parachute Payments

The other major consequence of an excess parachute payment situation is the loss by the payor corporation of its deduction with respect to such payment.[227]

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[219] §280G(b)(3)(B); Prop. Regs. §1.280G-1, Q&A-38(a).

[220] *Id.* Prop. Regs. §1.280G-1, Q&A-31, Q&A-32, and Q&A-33 contain rules for determining present value, and Prop. Regs. §1.280G-1, Q&A-34 defines "base amount."

[221] Prop. Regs. §1.280G-1, Q&A-38(b).

[222] §280G(b)(4) (last sentence); Prop. Regs. §1.280G-1, Q&A-39(a).

[223] H. Conf. Rep. No. 861, 98th Cong., 2d Sess. II-853 (1984).

[224] §§275(a)(6) and 4999. Thus, in 1989 and 1990, for example, an individual could be taxed at a rate of 48% (28% individual income tax rate plus 20% excise tax rate) on excess parachute payments for federal tax purposes.

[225] *See* Exhibit A at the end of this ¶ 5720.

[226] §§4999(a) and (c).

[227] §280G(a).

This deduction is essentially equal to 34% times the amount of such excess parachute payment. [228]

¶ 5720.07
Planning and Drafting Considerations

¶ 5720.07.A
General

There are a number of good business reasons for implementing golden parachute-type arrangements for executives, including the following:

- If such agreements are in place, key employees are less likely to leave the company when it is viewed as a likely takeover candidate, or upon the threat of a takeover.

- When a takeover is likely, key executives will focus their attention on managing the company and seeking the best financial terms for the company, rather than seeking other employment for themselves. This focus encourages management's objective evaluation of unsolicited takeover bids by mitigating concerns about post-acquisition employment and thus reduces the possibility that management's loyalty will be divided between the interests of shareholders and the interests of executives.

- In the case of a troubled company, such agreements may be a necessary incentive to attract key executives.

- To provide some amount of financial security for executives.

- To provide executives with a certain level of income if they are terminated because of a change in control.

When drafting a potential golden parachute-type agreement, the practitioner should consider the importance of the executive to the organization (especially following a change of control), the extent to which the retention of the executive is crucial during the change of control negotiation process, and the extent to which the executive's job position would be duplicative following any merger. In addition, the issue of what constitutes a change of control needs to be carefully considered. When defining change of control, the practitioner should consider whether a friendly takeover should be treated differently from an unfriendly takeover. For example, if a "white knight" appears, and the resulting merger is one that is supported by the existing board and management, the golden parachute-type agreement would not necessarily have to be triggered.

Furthermore, a practitioner should review the question of what constitutes a covered termination of employment. Most golden parachute agreements provide that the executive will be paid the stated severance compensation if the executive's employment is involuntarily terminated within a stated period (generally some number of years) following the change of control. Generally, involuntary termination is defined as termination of employment for any reason other than discharge for cause, long-term disability, death or normal retirement. Most agreements also cover an executive who resigns for "good reason," such as substantive changes in the executive's duties and responsibilities, reduction in the executive's pay and/or benefits, forced relocation of the executive, excessive travel, or changes in organizational reporting relationships. Care should be taken when defining these terms, however, to ensure that the company will only provide benefits in the situations that it desires to provide such benefits.

Finally, a practitioner drafting golden parachute-type agreements should address the issue of the degree of protection to be provided to the executive. Often, that level of protection is designed to conform to the maximum amount that may be provided without incurring the sanctions applicable to excess parachute payments under the Code. However, some golden parachute-type agreements provide for a "gross-up" in payments to compensate executives for the imposition of the 20% excise tax applicable to excess parachute payments, and often include a gross-up to cover the income taxes on such gross-up. Such a gross-up can, however, be extremely costly to the payor corporation.

Golden parachute-type agreements that are designed to avoid the application of the penalty provisions offer significant advantages to both the executive and the employer. For example, they provide the executive with security in the event of a change in control, thereby allowing the executive to act in the shareholders' financial interest rather than in his or her own interest. Moreover, large parachute contracts (whether or not subject to the penalty provisions) benefit an employer seeking to deter unwanted takeovers by operating as a "poison pill" type of defense to the takeover. However, the disadvantages of "excess parachute payments" are the potential loss of the corporate deduction for the payments and the potential excise tax penalty on the recipient of such payments. Finally, there is some risk that golden parachute payments may trigger shareholder suits for waste of corporate assets.

Although it might appear that the total amount of parachute payments should fall within the safe harbors under the Code and regulations, payments that are considered parachute payments for excise tax purposes include many benefits which might generally not be considered parachute payments based on an understanding of the policy behind the golden parachute provisions. Consequently, if the potential impact of the golden parachute provisions is not carefully considered in advance of a corporate acquisition or disposition, an executive may

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[228] Note that for parachute payments attributable to an incentive stock option (ISO) there may be no penalty to the employer since an employer does not generally receive a deduction with respect to an ISO unless the employee makes a disqualifying disposition of the employer stock acquired pursuant to such ISO. *See* §421(b). For a discussion of ISOs, *see* ¶ 5820, *infra*.

1044-7261/90/$0+.50

receive net benefits (after the imposition of the golden parachute excise tax and normal income taxes) which are substantially less than the amount he or she expected to receive, or that the executive would have received if the acquisition or disposition did not occur. Another reason that the safe harbors are often exceeded is that they are determined based on taxable compensation in prior years, and many executives currently have the ability to defer the income tax consequences on much of their compensation into later years. A close analysis of these provisions is therefore warranted in the case of any executive electing to defer compensation currently, who will receive termination payments and/or significant other benefits upon a change in control, so that adverse tax consequences with respect to such payments can be avoided by both the payee (excise tax) and payor (nondeductibility).

¶ 5720.07.B
Drafting Termination Agreements to Avoid Excess Parachute Payments

It is essential that executives with termination agreements be aware of the consequences of the golden parachute provisions, particularly the impact on their agreements. The major impact of the golden parachute provisions is their effect on traditional compensation methods and their effect on retirement contracts between publicly or privately held corporations and their key employees that are made, renewed or supplemented after June 14, 1984 that either: (1) contain vesting acceleration provisions that are triggered by a takeover; (2) are entered into within one year prior to a takeover; or (3) call for an increase in the present value of the payments to be received by such key employees in the event of a takeover by reason of accelerated payment, increased earnings rate on deferred compensation, etc. Payments created by these types of provisions will often constitute parachute payments and will, therefore, frequently be subject to the penalty provisions to the extent that the total parachute payments exceed the greater of "reasonable compensation" or the base amount allocable to each such payment. Since the burden of proof rests on the taxpayer to rebut the presumption that all parachute payments are unreasonable compensation, the nondeductibility and excise tax penalties are likely to be imposed in surprising numbers of cases upon some portion of the post-acquisition pay of officers, shareholders and highly paid individuals (even those individuals with no or non-abusive termination agreements). Only through careful tax planning to reduce the size of the parachute payments and persuasive arguments that parachute payments constitute reasonable compensation can the penalties applicable to excess parachute payments be avoided.

The uncertainty surrounding the interpretation of the golden parachute provisions raises two significant issues. The first is whether specific procedures and/or agreements should be adopted for determining the base amount, the threshold amount, total parachute payments and total excess parachute payments with respect to affected disqualified individuals. In the absence of a specific provision, the employer will have to make a determination; if the disqualified individual disagrees, he or she will have to take general enforcement action, *e.g.*, litigation or arbitration. Due to uncertainty over whether or in what amount certain types of payments will be treated as parachute payments, it may be in the executive's best interest to provide for a third-party determination (*e.g.*, by outside tax counsel) of the golden parachute payment consequences. If the executive is entitled to receive his or her full parachute payment or to elect a smaller amount to try to avoid golden parachute consequences, he will retain the best possible bargaining position and may be able to avoid the payment delays that could otherwise be imposed by a hostile successor employer. However, an executive's ability to elect to receive more than he actually receives could result in the constructive receipt and taxation of such larger amounts.

The second issue is whether the parties should provide for repayment of any amounts ultimately determined by the IRS to constitute excess parachute payments. In the unreasonable compensation area, repayment agreements have been successful in permitting taxpayers to avoid the double taxation (income to the employee and no deduction to the employer) associated with a finding of unreasonable compensation. In such a case, the employee is entitled to a deduction for the amount repaid, provided that the repayment agreement imposes a legal obligation to repay and the repayment requirements were imposed prior to or at the time of the original payment to the taxpayer, not by some subsequent voluntary agreement between the taxpayer and the corporation. [229] It is not clear, however, whether the IRS will respect similar repayment agreements in the golden parachute area.

Agreements designed to avoid the impact of the golden parachute provisions may take one of at least three approaches. The first is to provide that any payments which are found to constitute excess parachute payments will not be made. The problems with this approach include the issue of who will make the determination of whether the payments constitute excess parachute payments and what the standard will be for such interpretation (*e.g.*, reasonable interpretation, substantial authority, or a "more than likely" interpretation). In an unfriendly takeover, it will generally be undesirable to have the hostile raider determine the applicability of the golden parachute excise tax because the raider will

[229] *See, e.g.*, Rev. Rul. 69-115, 1969-1 C.B. 50; *see also Oswald v. Comr.*, 49 T.C. 645 (1968). For a discussion of reasonable compensation, *see* ¶ 5420, *supra* and 390 T.M., *Reasonable Compensation.*

probably interpret these provisions in a manner that limits the amount of the company's obligations to the smallest extent possible. Alternatively, the right of the executive to determine the applicability of the golden parachute provisions raises various constructive receipt issues and other questions that may substantially reduce the potential effectiveness of the cap on the benefits such disqualified individual is entitled to receive. Another problem with this approach is that the inclusion of such a provision in an agreement may be evidence that certain payments called for by the agreement are excess parachute payments. For example, a provision that limits the amount of compensation to be paid to amounts which are reasonable is evidence that certain amounts of compensation paid to that individual may not be reasonable. [230]

A second approach which may be used to avoid the impact of the golden parachute provisions is to take advantage of the safe harbor by limiting the amount payable under any parachute agreement to 299% of the base amount. However, an agreement providing payments upon a change in control equal to 2.99 times the base amount will generally provide too much or too little. For example, if there are any other parachute payments that trigger the Code's golden parachute provisions that are not used to offset the benefit under such safe harbor agreement, the agreement will provide too much. The combination of such other payments and the safe harbor severance payment will total more than 299% of the base amount, and anything that is not reasonable compensation for personal services actually rendered before the change of control will therefore be subjected to the adverse tax consequences. Alternatively, a limit of 299% of the base amount might be too little when compared to the maximum which such disqualified individual could receive without adverse parachute consequences. For example, some of the payments subject to the limit might not be parachute payments, or all of the parachute payments (including those provided by the agreement) might be reasonable compensation for personal services actually rendered. In the latter case, nothing would be subject to the adverse tax consequences even though the total parachute payments might be greater than 299% of the base amount. Use of the safe harbor language in change of control agreements also creates a communication problem because many of the affected executives will not receive the benefit they anticipated receiving pursuant to such agreements. For example, if the agreements provide for offset by parachute payments pursuant to other agreements, the executives' benefits under the agreements might be totally eliminated as a result of parachute payments under other plans that are equal to or in excess of the safe harbor threshold and which must be offset against the safe harbor benefit to avoid an excess parachute payment situation. This problem could be alleviated by eliminating the savings clause from the change of control agreement, but that would result in adverse tax consequences with respect to all payments exceeding the base amount which were not reasonable compensation for services previously rendered.

A variant of the second approach is to require recipients to return amounts in excess of the safe harbor amount and thus allow the executive to make the excess parachute payment determination, or to treat the payment of any amount in excess of 2.99 times the base amount as a loan (with interest at the AFR) to the disqualified individual. [231] In addition to the constructive receipt concerns discussed above, where this variation is utilized, it is not clear whether an executive's obligation to repay the excess amounts will eliminate the current income tax consequences and the excise tax penalty applicable to the executive, or the denial of the corporation's deduction, especially where payment and repayment occur in different taxable years. If such a repayment provision is ineffective, significant adverse tax consequences could result. For example, excess parachute payments paid to an individual could be subject to income and excise taxes in the earlier year of receipt, and in a later year, the individual might not be able to either eliminate the golden parachute excise tax consequences or obtain a deduction with respect to the amount he or she is legally obligated to repay to the corporation. Even if the disqualified individual is allowed to deduct such repayments, the value of such deduction might be reduced because of lower income tax rates in the later year in which such amount is repaid, [232] or because such amounts may be deductible only as other itemized deductions and, therefore, only to the extent they exceed 2% of adjusted gross income. [233] Further, the corporation might have to report the repayment as income, even though it received no deduction when it made the excess parachute payment to the disqualified individual. [234]

An executive designing his own golden parachute cap might prefer a cap that applies only if the parachute payments subject to the excise tax would cause his net

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[230] *Charles Schneider & Co. v. Comr.*, 500 F.2d 148 (8th Cir. 1974); *Saia Electric, Inc. v. Comr.*, T.C. Memo 1974-290 (1974), aff'd, 536 F.2d 388 (5th Cir. 1976), cert. denied, 429 U.S. 979 (1976).

[231] Arguably, Prop. Regs. §1.280G-1, Q&A-7(a)(2) could be interpreted to allow the repayment of excess parachute payments without the application of normal income taxes or the application of the adverse tax consequences of §§280G and 4999 on such amounts. That provision states that in order for payments by corporations whose stock is not readily tradable to be excluded from parachute payment status, the shareholders of such corporation must vote with respect to "the right of the disqualified individual to retain the payment." This suggests that such payments may be returned, presumably without adverse tax consequences, if the shareholder vote is unfavorable.

[232] Based on 1989 and 1990 rates, however, the reverse is more likely.

[233] *See* §67. For a discussion of the 2% floor on miscellaneous itemized deductions, *see* ¶ 2910, *supra*.

[234] The tax benefit doctrine might be applicable, however, to reduce or totally eliminate the amount of repayment which is taxable to the corporation. This doctrine is discussed in ¶ 1050, *supra*.

1044-7261/90/$0+.50

after tax benefit to be greater by applying the cap than by not applying it. For example, using 1989 income tax rates, once an individual's parachute payments increase above 299% of his base amount (assuming no parachute payments constitute reasonable compensation for services previously rendered), the individual's net after tax benefit remains lower than his net after tax benefit before the 299% threshold was surpassed until his total parachute payments equal or exceed 376.9% of his base amount. Thus, under the type of cap described in this paragraph, an executive would not elect to receive parachute payments in excess of 299% of his base amount unless such parachute payments fully exceeded 376.9% of his base amount. [235]

A third alternative — the gross-up alternative — is also possible but generally is desirable only from the executive's perspective. [236] Under this alternative, the employer grosses-up the executive's compensation to put the executive in the same financial position after the payment of the 20% excise tax, and income and excise taxes on such grossed-up amount, that he would have been in had the 20% excise tax not applied to any of the payments he received. There are two basic types of gross-up allowances. The first type provides an individual with a payment which is large enough to eliminate completely the impact of the parachute excise tax penalty. The second type of gross-up allowance provides an individual with a limited gross-up allowance by only making the executive whole to the extent certain payments that the parties did not anticipate being treated as parachute payments are so treated. Under this approach, payments that are expected to be treated as parachute payments are limited as provided for by the agreement. If other payments are treated as parachute payments, however, this type of gross-up only provides an individual with a payment that is large enough to place the individual in the same position, after payment of all excise and income taxes, that he would have been in if *these other* payments were not treated as parachute payments. The second type of gross-up is much less desirable from the employee's perspective. As reflected in Exhibit A, the cost of either type of gross-up allowance is generally very substantial to the corporation in relation to the benefits provided to the disqualified individuals.

A different type of planning idea that has developed to avoid an excess parachute payment situation is the execution of employment agreements and/or consulting agreements between the corporation and each disqualified individual for various terms, with such contracts being periodically renewed on an annual or monthly basis and providing for liquidated damages upon breach equal to the desired payments to the disqualified individual. [237] In order to make payments under such agreements fall within the concept of reasonable compensation for future services — and thus outside the definition of parachute payments — such agreements should generally limit damages to the present value of the compensation the disqualified individual would have received had he worked for the entire contract term and should also contain provisions relating to mitigation. Payments under such agreements could be in lieu of existing termination agreement payments (presumptively non-reasonable compensation parachute payments). Moreover, the amounts provided under such employment and/or consulting agreements must be "reasonable" compensation for the services to be rendered.

Some issues which must be addressed when trying to convert termination agreement payments into employment contract payments are:

1. What is the appropriate duration of the contract? Remember that the contract's duration significantly impacts upon both the ultimate damages for breach thereof and the period during which mitigation is required in the event of breach of the contract. Also, the term of the employment agreement should presumably be such that the executive is protected to the same extent as he was under the termination agreement in the event of a change in control.

2. Is a daily perpetually renewing contract for a specified term viable under the proposed regulations?

3. What methods of mitigation are possible? Can the damage be calculated by discounting them to reflect the likelihood that other employment will be obtained? Is mitigation required for compensation which is deferred? Is a present value form of mitigation permissible? For example, assume an employment contract has three years remaining as of the date of the change of control, and the present value of the damages under the contract are such that of the $150,000 of damages for breach of contract, the present value attributable to the remaining years is $65,000 for Year 1, $50,000 for Year 2, and $35,000 for Year 3. If the disqualified individual subsequently obtains a job in Year 3 paying him or her $150,000 per year, it would appear that he or she should only be required to mitigate to the extent of $35,000,

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[235] *See* Exhibit A. Also note the potential constructive receipt problems with this type of approach. The constructive receipt problems could be minimized by making the cap automatically effective, rather than electively effective, if the net after tax benefit would be greater.

[236] Note that the company implementing the gross-up will not be the one that pays the bill. Instead, since the gross-up only applies upon a change of control, the acquiring company will pay the bill, and thus, the gross-up functions similar to a "poison-pill defense." A partial gross-up possibly can be provided, without calling it such, by prohibiting the payor corporation (or its successors or assigns) from withholding any excise tax from termination agreement payments pursuant to the terms of such agreements.

[237] *See* ¶ 5720.03.H, *supra*. Note that, since the 1-year presumption has no relevance with respect to compensation for services to be rendered following the change of control, the time when the contract was entered into is not that important for this purpose as long as the contract is not executed when the change of control is imminent. Prop. Regs. §1.280G-1, Q&A-42(b)(1). A conservative employer should, however, draft its employment agreements (and periodic renewals) to take advantage of the safe harbor rebuttal of the 1-year presumption described in Prop. Regs. §1.280G-1, Q&A-26(b)(2).

rather than the full $150,000 compensation from the new employer.

4. Who decides whether or not to withhold golden parachute excise taxes with respect to payments under such employment contracts? If the acquiring company makes the decision, will the underlying reasons for creation of such agreements be adversely affected?

5. Should there be some leeway in the damage calculation to be sure the safe-harbor is not exceeded? [238]

6. Is it possible to provide for different rules in non-change of control situations than change of control situations (*e.g.*, different methods of mitigating breach of contract damages, or different events which trigger breaches of the contracts)?

To some extent, conversion of existing golden parachute termination agreement payments into payments for services to be rendered (or breach of contract payments) under employment agreements can be accomplished by using consulting/non-compete/non-disclosure agreements. However, there are some distinct advantages of using employment contracts instead of these other types of agreements. First and most importantly, the proposed regulations substantially defeat the contemplated use of consulting agreements (*i.e.*, payments for being available to work rather than actually working) by requiring that the disqualified individual only receive compensation for services actually performed, or alternatively, damages for breach of contract. [239] Another advantage of employment contracts over consulting agreements is that a greater value can be assigned to the time that the executive will be (or would have been) working on a full-time basis than can be assigned to the value of that same executive's consulting services after his employment has been terminated (unless there is an assumption in the latter case that the executive was to actually consult on a full-time basis and his consulting services would be as valuable as his current services).

An alternative to converting termination agreement payments into reasonable compensation for services to be rendered in the future is converting them into reasonable compensation for services previously rendered. Of course, these payments might still be parachute payments and result in adverse parachute consequences unless all parachute payments are converted into reasonable compensation for services previously rendered.

One way of converting termination agreement payments into reasonable compensation for services previously rendered is to modify an existing SERP [240] to provide an increased benefit of 100% of final year's compensation, which could presumably be done without any major risk of concern as to the reasonableness of the compensation. Executives could then give up part of their golden parachute-type termination agreement payment in exchange for this increased SERP benefit. This proposal is consistent with legislative history [241] and converts termination agreement payments (presumed by the legislative history not to be reasonable compensation for services previously rendered) into nonqualified pension benefits, *e.g.*, reasonable compensation for services previously rendered (at least to the extent that such benefits are appropriately discounted for the probability that they would have been forfeited by the executive). Thus, even if such additional benefits continue to be classified as parachute payments (like the termination agreement payments which they are replacing) they are converted into reasonable compensation for previously rendered services against which no excise tax is imposed (*e.g.*, because their vesting is triggered by the change in control). [242] The safe harbor in the proposed regulations significantly limits the availability of this planning idea to older executives with respect to additional unvested SERP benefits where the vesting is dependent upon a future service requirement. [243] Of course, if these additional SERP benefits were vested as service was performed, they could be removed from the status of parachute payments (except to the extent of any parachute consequences attributable to accelerated payment), and this planning idea would be available for all disqualified individuals (not just older disqualified individuals). However, many companies may not be willing to go as far as vesting such benefits upon any termination of employment since the executives would be entitled to such vested benefits upon any termination of employment (whether or not in connection with a change of control).

The major issues with respect to the use of SERPs as a method to avoid golden parachute consequences are: (1) actuarial valuation issues regarding the probability that SERP benefits would have been forfeited; (2) questions as to whether the disqualified individuals and the company can prevail against the IRS on a facts and circumstances basis as to the likelihood that the benefits

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[238] *See* Prop. Regs. §1.280G-1, Q&A-42(b)(3). There is a possibility that if the damages exceed the safe harbor by a single dollar, the entire amount of damages (not just the excess above the safe harbor) constitutes a parachute payment pursuant to Prop. Regs. §1.280G-1, Q&A-42(b).

[239] *See* Prop. Regs. §1.280G-1, Q&A-42. Note, also, that it has been suggested by IRS personnel that payments pursuant to covenants not to compete cannot constitute reasonable compensation for services to be rendered pursuant to Q&A-42. However, these amounts might be excluded from parachute payments status under Q&A-22 and Q&A-24 if it is substantially certain, at the time of the change of control, that such payments would have been made whether or not the change of control occurred.

[240] *See* ¶ 5710.02.1.1, *supra*, for a discussion of SERPs.

[241] *See* Tech. Corr. Bluebook at 29.

[242] Of course, these payments might still be parachute payments and result in adverse tax consequences unless all parachute payments constitute reasonable compensation for services previously rendered.

[243] Prop. Regs. §1.280G-1, Q&A-24(c) effectively eliminates the benefit of this planning idea for any executive who is not within 8-1/3 years of the vesting date for such benefits [8.333 × 12 months × 1% equals 100%, *i.e.* 1% per month of unperformed service to reflect the waiver of the service requirement with respect to payments which would have been made had the individual continued to perform services for the corporation until some future date, *e.g.*, age 65].

1044-7261/90/$0+.50

will be paid where the plan document says that vesting is contingent upon a stated event which has not yet occurred; and (3) concern that the company would not want to obligate itself to pay these benefits in cases other than a change of control (*i.e.*, to the extent the use of this planning idea required that the benefits become vested).

Finally, another method of converting golden parachute-type termination agreement payments into reasonable compensation for services previously rendered is for a corporation to make more extensive use of stock options which vest over a period of future employment (or immediately vest) as a compensation technique. [244] Of course, if such options are immediately vested, there is the risk of a windfall to the executive upon termination of employment for reasons other than a change of control. Again, the options could be received in exchange for existing termination agreement payments. Another problem with this planning idea is that it does not allow for the current measurement of the amount of benefit which is being provided to disqualified individuals (due to the uncontrollable fluctuating spread between the option price and the price of the payor corporation's common stock). Additionally, shareholder approval may be required to issue additional company stock to implement this proposal, and/or shareholder approval of the additional compensation may be required.

To summarize, the following planning opportunities to avoid golden parachute consequences have been outlined above:

- Conversion of termination agreement payments into payments for consulting/non-compete/non-disclosure agreements;
- Conversion of termination agreement payments into payments under employment contracts, or payments for liquidated damages for breach of such contracts;
- Conversion of termination agreement payments into increased SERP benefits;
- More extensive use of stock options which are earned when granted, but which vest either immediately, or over a vesting schedule contingent upon future service (with immediate vesting upon a change of control);
- Reliance on the idea that a portion of the existing termination agreement payments constitutes reasonable compensation for services previously rendered by the disqualified individuals (*i.e.*, it is not within the definition of severance pay in the proposed regulations because it is payable in all events); and
- Utilize termination agreements with a 2.99 times base compensation trigger. These agreements could provide for either benefits equal to the full 2.99 times the base amount (with either a partial gross-up or full gross-up in cases where other parachute payments exist which cause the safe harbor limit to be exceeded), or benefits equal to some lesser percentage of the base amount (in order to allow for the existence of other parachute payments without automatically creating excess parachute payments).

Of course, different ideas can be used for different disqualified individuals, and more than one idea can be used for the same disqualified individual.

Some other planning ideas to avoid the application of the adverse tax consequences of the golden parachute provisions include the following:

- To protect a top executive who moves from a secure job to a new job, and who is concerned about a subsequent takeover of his new company, an alternative to a parachute agreement would be to give the executive a sign-up bonus (similar to what is done for athletes). Such bonuses are generally not contingent on a change of control because they are made upon commencement, rather than upon termination, of employment. In addition, a sign-up bonus may substantially increase the employee's base amount, giving further protection to other payments. These types of payments are specifically condoned by the proposed regulations. [245]
- Another idea involves developing methods of accumulating qualified plan benefits for individuals who might be affected by the golden parachute provisions, in order to take advantage of the exemption from parachute payment status of payments from qualified plans. For example, KEOGH plans could be established for the fees of directors to accumulate additional qualified plan benefits on their behalf. Also, the rate of pay for affected individuals could be increased, or the calculation of the pay upon which pension accruals are based could be modified to include other types of compensation (subject to the $200,000 limit [246] with respect to qualified plans), to increase the qualified pension plan benefits of disqualified individuals. Additional methods of increasing qualified plan benefits could also be formulated, including methods utilizing existing excess pension assets. [247]

The best alternative may be a combination of the various proposals outlined above. One goal could be to convert enough of the contemplated parachute payments into reasonable compensation for future services so that an excess parachute payment situation does not exist. Another goal could be to convert all of the contemplated parachute payments into reasonable compensation for services previously rendered so that, even though an excess parachute payment exists, there are no excise tax consequences to the executives and no loss of deductions by the corporation.

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[244] This idea concerns the effects of Prop. Regs. §1.280G-1, Q&A-24. *See also* the discussion in ¶ 5720.03.B, *supra*.

[245] Prop. Regs. §1.280G-1, Q&A-35(b) (Example 2) and Q&A-36(b) (Example 2).

[246] As adjusted for inflation, the $200,000 limit was increased to $209,200 for 1990.

[247] For a discussion of various types of qualified plans, *see* ¶¶ 5500 *et seq.*, *supra*.

To the extent that the acquiring corporation is making the payments at issue, it can always effectively modify any planning decision by treating certain payments as excess parachute payments, (*e.g.*, by withholding the 20% excise tax, unless it is prohibited from doing so by the terms of the underlying contract) even though the acquired corporation was of the opinion that the payments at issue would not constitute excess parachute payments. This factor must be considered in connection with any golden parachute planning ideas.

In addition, the corporation should always consider the payment of legal fees incurred by disqualified individuals in connection with the payment of any potential parachute payments, since such payments are excluded from the concept of "payments in the nature of compensation." [248]

Many lawsuits have been instituted challenging golden parachute and other executive compensation arrangements on various grounds, such as the validity of employment agreements taking effect upon a change in control, the immediate funding of unfunded deferred compensation benefits, the amendment of officers' employment contracts to provide greater benefits, the creation of golden parachute contracts, the creation of rights to receive the present value of future salary, the acceleration of the exercisability of stock options, and the granting of stock options, all triggered by a change of control. When drafting golden parachute agreements, practitioners should be aware that shareholders may eventually contest those agreements by claiming that golden parachutes are a waste of corporate funds and are a form of self-dealing, and practitioners should draft the agreements to address these concerns.

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[248] Prop. Regs. §1.280G-1, Q&A-11(a). Moreover, the payment of legal expenses could be even broader in the case of disputes arising between the company and a disqualified individual following a change of control.

1044-7261/90/$0+.50

EXHIBIT A

Net Costs and Benefits of Golden Parachute Payments — 1989 & 1990

1989 & 1990 Individual rate:	28%			
1989 & 1990 Corporate rate:	34%			
Parachute Payments		$376,923	$300,000	$299,999
Average Annual Includible Compensation (Base Amount)		100,000	100,000	100,000
Safe Harbor [249]		299,999	299,999	299,999
Excess Parachute Payments [250]		276,923	200,000	- 0 -
Net Payment to Individual After Income Taxes [251]		271,384	216,000	215,999
20% Excise Tax on Excess Parachute Payments		(55,384)	(40,000)	- 0 -
Net Benefit to Individual [252]		$216,000	$176,000	$215,999
Net Cost to Company [253]		$342,923	$266,000	$197,999

[249] 2.99 times the base amount.

[250] Parachute payments less base amount, *if* parachute payments *exceed* safe harbor. These amounts are subject to excise tax and loss of the tax deduction by the payor corporation.

[251] Parachute payments times 100%, less 28%.

[252] Net payment less 20% excise tax.

[253] After considering the tax benefit to the Company of any deductions to which it is entitled. Total parachute payments less 34% of difference between total parachute payments and excess parachute payments.