COMPENSATION & BENEFITS

Section 280G Excise Tax Planning and Mitigation

Change in control ("CIC") arrangements have become an effective way to attract qualified candidates and to reward top performers for their success. CIC arrangements are commonly put in place to ensure that executives evaluate every opportunity (including a merger or acquisition) with an eye toward maximizing shareholder value, without worrying about how such an event will affect their personal circumstances.

When a CIC does occur, the CIC arrangements will trigger payments which could subject both the corporation and key executives to significant adverse tax consequences under the Golden Parachute provisions of the Internal Revenue Code (Sections 280G and 4999).

Overview of Golden Parachute Rules

Golden Parachute payments to an executive[1] that exceed a "safe harbor" limit could trigger significant tax consequences to both the corporation and the executive. Depending on the circumstances and the number of executives affected, the cost to the corporation and the executives could be substantial.

- Golden Parachute payments can include severance payments, deal bonuses, accelerated vesting and payment of equity awards (such as stock options or restricted stock), fringe benefits, and excise tax gross-up payments.
- The "safe harbor" limit that determines whether the company or executives will be impacted by the Golden Parachute rules is equal to 300% of the executive's Base Amount. Base Amount is calculated as the average gross compensation over the 5 most recent calendar years ending before the CIC date.
- When an executive receives payments exceeding the "safe harbor" limit, the Golden Parachute rules impose a 20% excise tax on the executive and disallow a deduction to the corporation for the related compensation.
- The excise tax and loss of deduction is imposed on any "excess parachute" amount. The excess parachute amount is determined based on the value of the executive's parachute payments, less 100% of the executive's Base Amount.

The most common situations where the Golden Parachute penalties could be triggered include:

- A company that has a significant amount of equity-based compensation awards outstanding (e.g., stock options, restricted shares, performance shares) that accelerate upon a CIC and/or termination;
- Severance payments triggered in connection with a CIC, which typically pay 2x - 3x annual salary and bonus; and
- New hires or newly promoted executives whose historical compensation amounts do not yet reflect their current position, which results in a lower "safe harbor" limit.

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[1] *Although we use the term "executive" in this article, the Golden Parachute rules would apply to any Disqualified Individual. A* ***Disqualified Individual*** *is anyone who (a) is an employee or independent contractor who performs personal services for a corporation and (b) is an officer, shareholder or highly compensated individual.*

- ***Officer*** *– no more than 50 employees (or, if less, the greater of 3 employees or 10 percent of all employees).*
- ***Shareholder*** *– only individuals who own stock of a corporation with a fair market value exceeding 1 percent of all outstanding stock. Constructive ownership rules apply.*
- ***Highly compensated individual*** *– limited to highest-paid 1 percent of all employees, not to exceed 250 in total. Minimum annual compensation of $130K.*

The illustration below shows a scenario where parachute payments to an executive can cost the corporation and the executive a significant amount of money:

	Scenario 1 No Golden Parachute Penalty	Scenario 2 No Golden Parachute Penalty
Total compensation paid in connection with the CIC	$1,499,999	$1,500,000
Average "Base Compensation" received in prior 5 years	$500,000	$500,000
280G Threshold	$1,499,999	$1,499,999
Over 280G Threshold?	No	Yes
Amount over/under 280G Threshold	$-	$1
Excess parachute payment	N/A	$1,000,000
Excise Tax penalty to executive (20%)		$200,000
Initial lost tax deduction to corporation (21%)		$210,000
TOTAL COST TO EXECUTIVE & CORPORATION		$410,000[2]

[1] In scenario 1, excise tax is not imposed on the executive and the corporation retains the full tax deduction since payments do not exceed the golden parachute "safe harbor" limit.
[2] In scenario 2, the payment of an additional $1 causes the executive to be liable for a $200,000 penalty and the corporation to lose $210,000 in tax benefits.

Excise Tax Mitigation Alternatives

With the use of excise tax gross-ups waning over the past several years, fewer executives are fully protected from the potential impact of the excise tax levied under the Golden Parachute rules. Coupled with the increasing popularity of performance-based equity vehicles (which are generally costlier under Section 280G), more executives have the potential to be hit with a large and unexpected tax bill. Accordingly, it is now more important than ever to consider excise tax mitigation alternatives.

Mitigation Alternative	Detail
Pre-Change in Control Reasonable Compensation	Section 280G provides that an excess parachute payment is reduced by the portion of the payment established by clear and convincing evidence to be reasonable compensation for personal services rendered before the date of the change in control. Examples: Prorated annual bonus and performance-based incentives.
Post-Change in Control Reasonable Compensation	Section 280G provides that the amount treated as a parachute payment does not include the portion of a payment established by clear and convincing evidence to be reasonable compensation for personal services to be rendered on or after the date of the change in control. • A common payment that can be treated as post-change in control reasonable compensation is a payment for a covenant not to compete that is intended to keep an individual from competing with their employer after the change in control. An expert valuation of the covenant not to compete should be performed. Other Examples: Consulting agreements and retention bonuses.
Base Amount Planning	If it is known far enough in advance that a change in control will occur in a future calendar year, there may be an opportunity for base amount planning. It would be advantageous to include as many payments as possible in a disqualified individual's income in the calendar year prior to the calendar year including the date of the change in control. This will increase the base amount and Section 280G threshold of the disqualified individual, which can lower or completely eliminate any excess parachute payments. Limitations imposed by Section 409A should be considered when accelerating any payments.
Private Corporation Shareholder Vote	Private corporations can "cleanse" Golden Parachute payments with a shareholder vote. Executives must disclose their payments and put their payments "at risk" through a binding vote of all shareholders. At least 75% of shareholders must approve of the payments in order for the Golden Parachute payments to be paid in full without any adverse impact of Code Sections 280G and 4999.

Change in Control Planning Considerations

Although there are a few excise tax mitigation alternatives that can be utilized around the time of a CIC, it is prudent to ensure that an executive's CIC arrangement is designed for success. Many pitfalls can be avoided through compensation plan design that considers tax implications, regulatory hurdles, and shareholder concerns. With respect to the design and implementation of CIC arrangements, companies should consider the following:

- Benchmarking existing plans to the current market allows public company boards, their compensation committees and management to validate existing CIC benefits or identify opportunities for change. Severance multiples, equity acceleration triggers, and other CIC benefits should be reviewed to ensure alignment with the market. **Please see the A&M 2019/2020 Executive Change in Control Report for more information.**
- Accelerated vesting of equity awards upon a CIC could have a significant Golden Parachute impact, depending on the normal-course vesting criteria of the awards. The Golden Parachute rules favor time-vesting awards, which are typically valued at less than their economic value when calculating their Golden Parachute impact. Performance-vesting awards are not eligible for this reduced valuation and tend to have a greater Golden Parachute impact. Potential excise tax implications of the Golden Parachute rules should be considered, among various other factors, when granting equity awards.
- The Securities and Exchange Commission (SEC) requires public companies to quantify any parachute payments the CEO and other NEOs would receive upon a hypothetical CIC at year-end and must disclose those amounts in the annual proxy statement. This provides transparency so that shareholders can weigh in on the company's pay practices through their say-on-pay votes. Management and Boards should consider how shareholders and advisory firms might view the company's current Golden Parachute arrangements.
- There are various excise tax protections that companies can utilize, such as gross-ups, "best-net" provisions, or cutbacks. Gross-ups have fallen out of favor and significantly declined in prevalence over the past several years, while "best-net" provisions have gained popularity. These excise tax protections help reduce the impacts of the Golden Parachute rules, but even with these provisions the Golden Parachute rules oftentimes still prove costly to executives and corporations.

Alvarez & Marsal's 280G Calculation and Mitigation Process

Prior to or in anticipation of an actual CIC, it is critical to calculate the value of an executive's parachute payments and whether or not the payments would trigger excise tax consequences under various scenarios.

- A&M can identify planning opportunities and implement proven techniques to help mitigate the excise tax impact on affected individuals and reduce the lost tax deduction for the company by taking the following steps:

STEP 1	Calculate the value of parachute payments received, such as severance payments, acceleration of equity awards, enhanced benefits and other non-cash compensation.
STEP 2	Assess whether excess parachute amounts exist and, if so, calculate the excise tax due for each individual.
STEP 3	Calculate the overall parachute costs, excise tax, gross-ups, cutback amounts, "better after tax" analysis and lost deductions to the company.
STEP 4	Perform alternative calculations utilizing different assumptions and scenarios to help you prepare for any contingency.
STEP 5	Estimate the fair market value of non-competition agreements (including non-solicitation clauses), with a detailed, narrative report supporting our valuation conclusions.
STEP 6	Explore Section 280G mitigation alternatives and executive excise tax protections.
STEP 7	Develop a detailed written report, outlining individual parachute calculations and combined cost to the company, and fact-based recommendations to avoid triggering the application of Section 280G deduction denials and IRC section 4999 excise taxes.
STEP 8	Draft Opinion Letter that summarizes the results of your 280G calculations.
STEP 9	Prepare employee communications to convey the essential information impacted individuals (and their tax preparers) will need to file their personal tax returns.

Conclusion

Boards of directors and compensation committees need to remain attentive to changing market trends and be ready to respond when challenges arise regarding the benefits provided to executives. When designing compensation programs, the potential impact of the Golden Parachute rules should be considered. As soon as it is determined that a CIC may be on the horizon, the company should take steps to understand the impact of the Golden Parachute rules to both the company and the executives.

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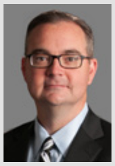

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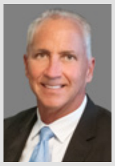

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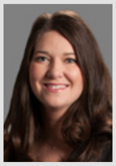

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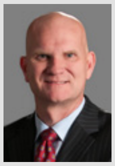

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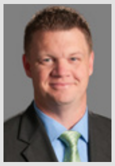

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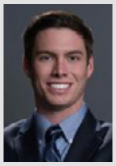

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