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U.S. Golden Parachute Rules in International Transactions: Sections 280G and 4999, Strategies to Avoid Tax Pitfalls

WEDNESDAY, OCTOBER 12, 2022

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Today's faculty features:

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Cross-Border Implications of Section 280G & Section 4999

October 2022

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The Golden Parachute Tax Regime

- The “golden parachute” excise tax regime under International Revenue Code Sections 280G and 4999 (“Section 280G” and “Section 4999”, respectively) is at the core of both public and private U.S.-based transactions.
- While Sections 280G and 4999 are typically associated with U.S.-based transactions, these regulations can, and often do, cross borders in transactions without obvious U.S. connections.
- Further, golden parachute considerations must also be identified in any cross-border, non-U.S. transaction if a non-U.S. corporation at any level of the transaction structure either (1) employs a U.S. taxpayer or (2) takes a U.S. compensation tax deduction.

Key Deal Items that May Indicate Golden Parachute Concerns

- More simply put, golden parachute issues may arise in any circumstance where any of the below variables are implicated in the broader transaction:
  - There are U.S. taxpayers implicated in the transaction; or
  - There are U.S. companies implicated in the transaction (whether public or private); and
  - There are payments tied to a “Change-in-Control” as a result of the transaction.

What are Sections 280G and 4999?

- Enacted in 1984, the “golden parachute” tax under Internal Revenue Code Sections 280G and 4999 has a significant impact in regards to “change in control” payments.
- Section 280G provides for a dual penalty on excess parachute payments made by a corporation (other than S Corps) to certain executives (or, “disqualified individuals”) in connection with “changes in control” or “CIC” in acquisitions, mergers and other similar corporate transactions.
  - Section 280G – denies a deduction to a corporation for amounts paid to an executive that is deemed to be an “excess parachute payment”.
  - Section 4999 – imposes a 20% excise tax on the executive for any excess parachute payments.

When are Sections 280G and 4999 Triggered?

- Corporations undergoing a change (i) in the ownership or effective control of the corporation, or (ii) in the ownership of a substantial portion of the assets of the corporation.
  - Change in the ownership: acquisition of at least 50% of the FMV or total voting power of a corporation's stock.
  - Change in a substantial portion of the assets: acquisition of assets with an FMV of at least one-third of the total gross assets of the corporation (without regard to liabilities).
  - Change in the effective control of the corporation: acquisition of 20% of more of the corporation's voting power or a majority of the board of directors is replaced (without the endorsement of a majority of the board prior to the change).

When are Sections 280G and 4999 Triggered? (cont'd)

- If any affiliated group entity experiences a CIC, the entire structure is implicated in 280G analysis.
  - All members of an affiliated group (as defined under IRC Section 1504) are treated as a single corporation.
  - This does not apply to partnerships or LLCs that have not elected to be taxed as corporations.
  - ***BUT***, keep in mind whether any corporations are involved in the overall deal structure – this could implicate excess parachute payment liability.

Excluded Entities

- Section 280G applies to both public and private corporations including:
  - Code Section 7704(a) publicly traded partnerships;
  - Code Section 856(a) real estate investment trusts;
  - Mutual or cooperative corporations;
  - Foreign corporations; and
  - Tax-exempt Code Section 501(a) corporations (in certain cases).
- Section 280G does **not** apply to payments from a "small business corporation" under Code Section 1361 (also known as "S corporations").
  - **Note**: The S-Corporation does not need to have ***formally*** elected S-Corporation status.

When is a Payment Contingent on a CIC?

- When a payment would not have been made had no CIC occurred.
  - Applies even if the payment is conditioned on the occurrence of another event (e.g., a termination of employment on or following a CIC).
- Presumed to be contingent on a CIC if the event occurs within 1 year before and ending 1 year after CIC.
  - Rebuttable presumption: certain payments may be reduced if taxpayer establishes by clear and convincing evidence that the payment (or a portion) is reasonable compensation on or after CIC.
- Not contingent if substantially certain that payment would have been made whether or not the CIC occurred.

When is a Payment Contingent on a CIC? (cont'd)

- Generally, the entire payment would be treated as contingent on a CIC.
- However, if a payment would be subject to continued service and the vesting is accelerated as a result of a CIC, then treat a portion of the payment as contingent on a CIC (Treas. Reg. Section 1.280G – Q/A 24(c)).
- Also, if the payment of a vested amount is accelerated as a result of a CIC, then treat a portion of the payment as contingent on a CIC (Treas. Reg. Section 1.280G – Q/A 24(b)).
- Payments under agreements first entered into after a CIC generally cannot be contingent on the CIC.

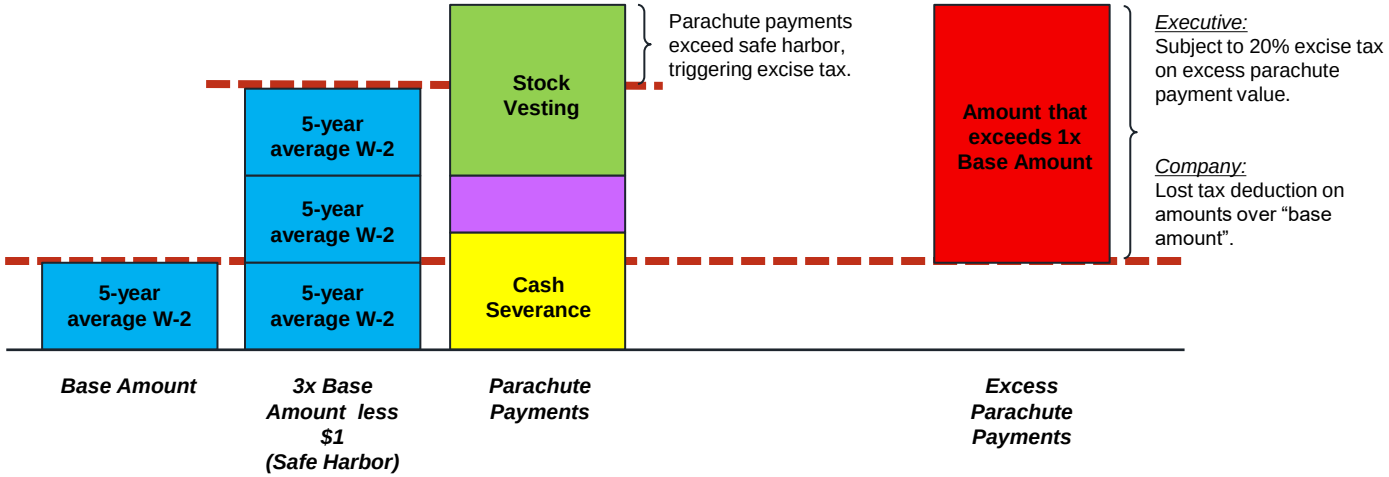
Types of Payments Implicated in Golden Parachute Analysis

Yes	No	Maybe
Severance or benefits continuation package	Payments in respect of fully vested equity	Wages and salary, bonuses and other cash compensation – Changes within 12 months pre-CIC
Transaction/CIC bonuses	Certain payments pursuant to a “tax receivables” agreement	Fringe benefits, life insurance and deferred compensation, depending on terms and conditions
Accelerated equity vesting		Equity or equity-based grants, entered into within 12 months prior to CIC
Accelerated vesting or payment of other payments		Retention Bonuses
Pro-rata bonus or deemed satisfaction of performance criteria		Other extraordinary payments made within 12 months pre-CIC
Excise tax gross-up payments		

Parachute Payment Thresholds

- Payments constitute “excess parachute payments” if the aggregate present value of such payments equals or exceeds three times a disqualified individual’s “Base Amount”.
- “Base Amount” is the average annual compensation includable in the disqualified individual’s gross income for the five completed calendar years preceding the Change in Control date (or if employed by the corporation for fewer than five full calendar years, the compensation averaged over the years during which the disqualified individual was employed).
- The excess parachute payment is the total parachute payments less the base amount.

Parachute Payment Thresholds



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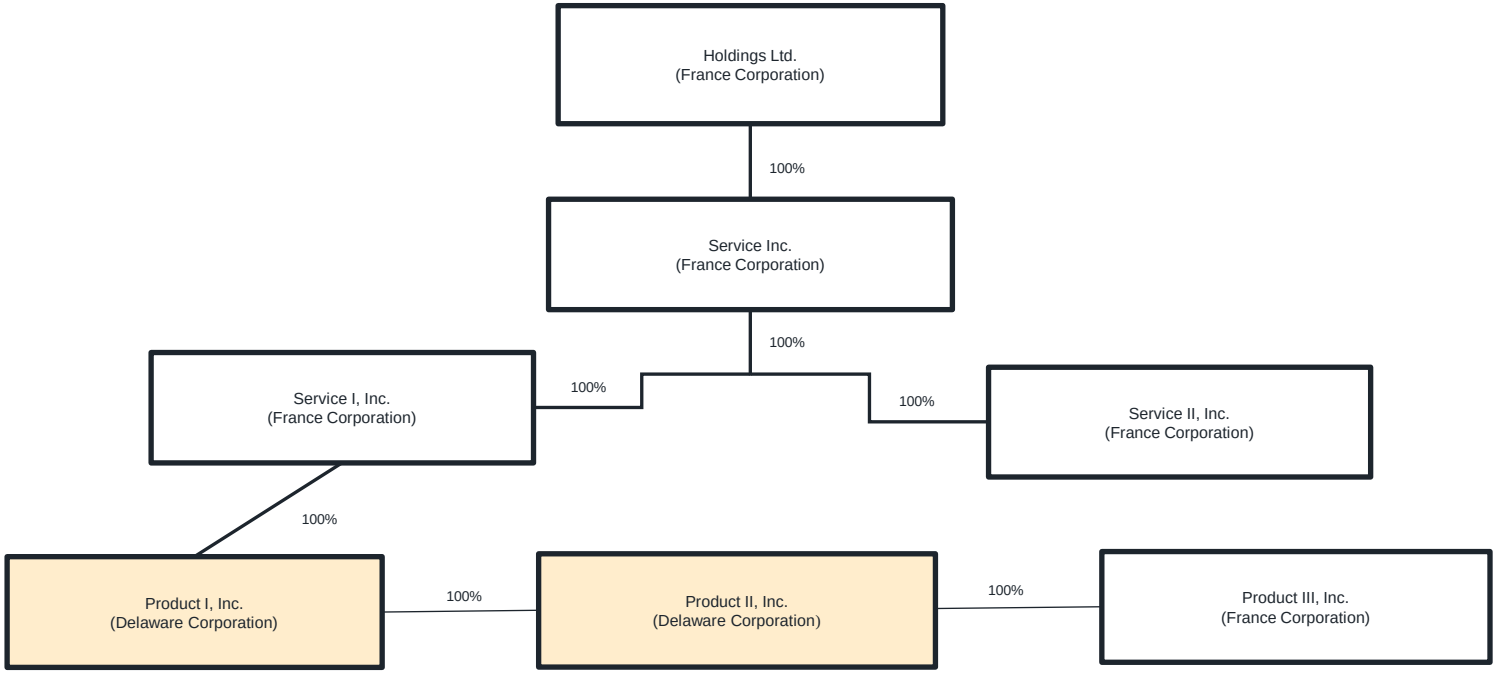
Who is a Disqualified Individual?

- An individual is a “disqualified individual” if, any time during the 12-month period prior to and ending on the CIC, such individual is:
  - An employee or an independent contractor; and
  - With respect to the corporation, an (i) officer, (ii) 1% shareholder or (iii) highly compensated individual (“HCI”).
- Officer determination based on “facts and circumstances”
  - Presumption if the individual has an “officer” title;
  - Defined as an “administrative executive who is in regular and continued service”;
  - The number of employees that can be treated as disqualified individuals by virtue of being an “officer” cannot exceed the lesser of 50 employees, or the greater of 3 employees or 10% of the total control group employee population.
- “HCI: is generally defined as lesser of (i) highest paid 1% or (ii) 250 highest paid employees (compensation must be in excess of IRS HCE compensation limit; $135,000 for 2022).
  - The tipping point for this HCI analysis is **25,000** employees.

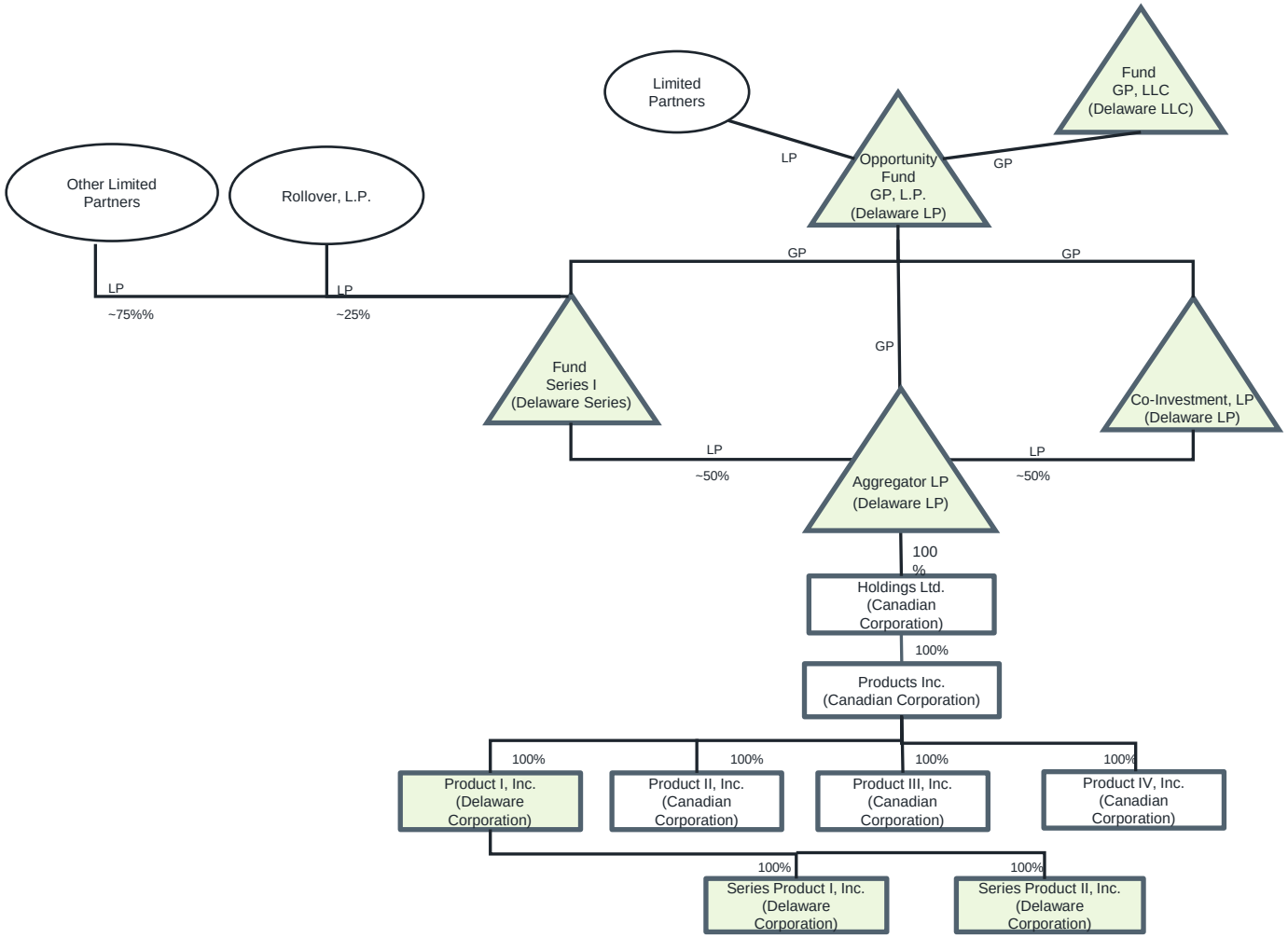
Non-U.S. Persons

- Section 280G may apply to a foreign corporation (within the meaning of Code Section 7701(a)(5)) if such corporation:
  - (1) employs a U.S. taxpayer who would qualify as a disqualified individual; or
  - (2) would have U.S. compensation deductions for payments to an individual who would be a disqualified individual.
- The deduction disallowance under Section 280G does not depend on the imposition of the excise tax under Section 4999, and the converse is true as well.
- This makes it possible that Section 280G could apply to a transaction involving two non-U.S. corporations that does not otherwise have a U.S. aspect, if the corporation undergoing the Change in Control has disqualified individuals who are subject to U.S. tax.

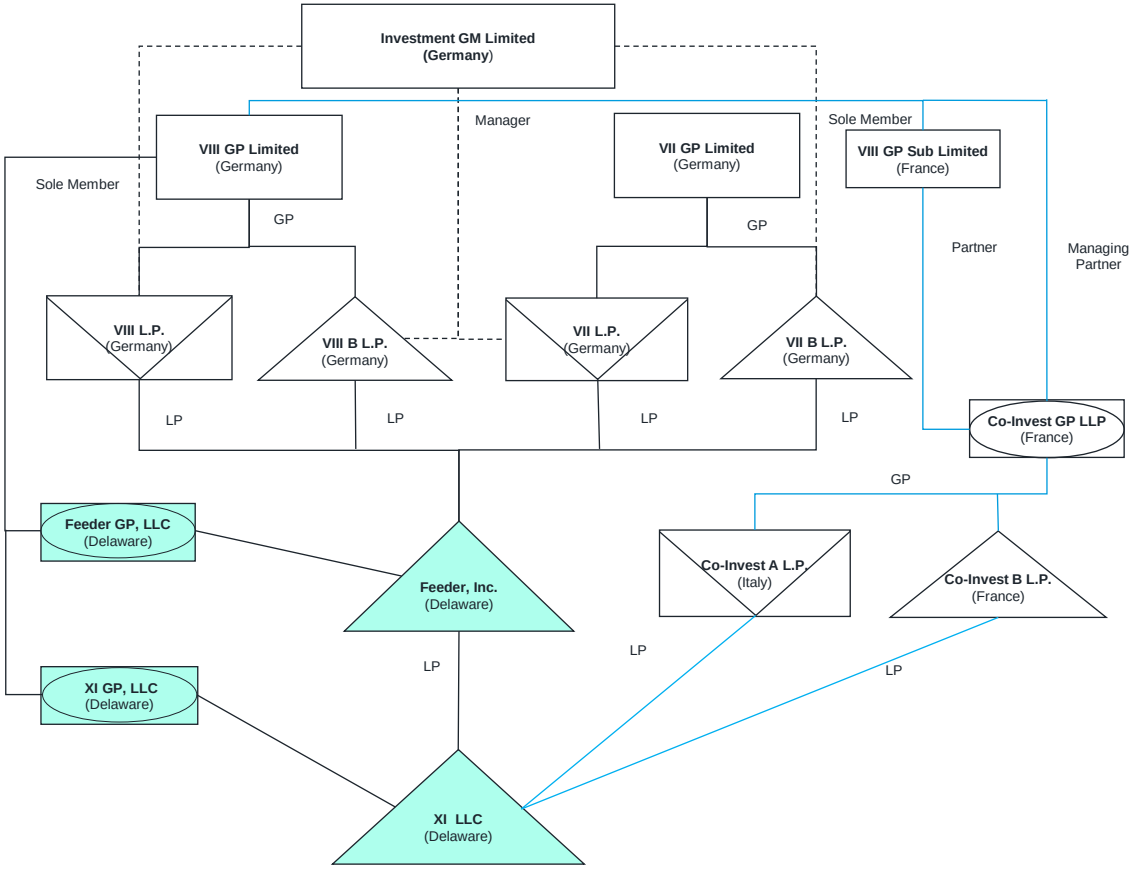
Example One


Holdings Ltd.
(France Corporation)
100%
Service Inc.
(France Corporation)
100%
Service I, Inc.
(France Corporation)
100%
100%
Service II, Inc.
(France Corporation)
100%
Product I, Inc.
(Delaware Corporation)
100%
Product II, Inc.
(Delaware Corporation)
100%
Product III, Inc.
(France Corporation)

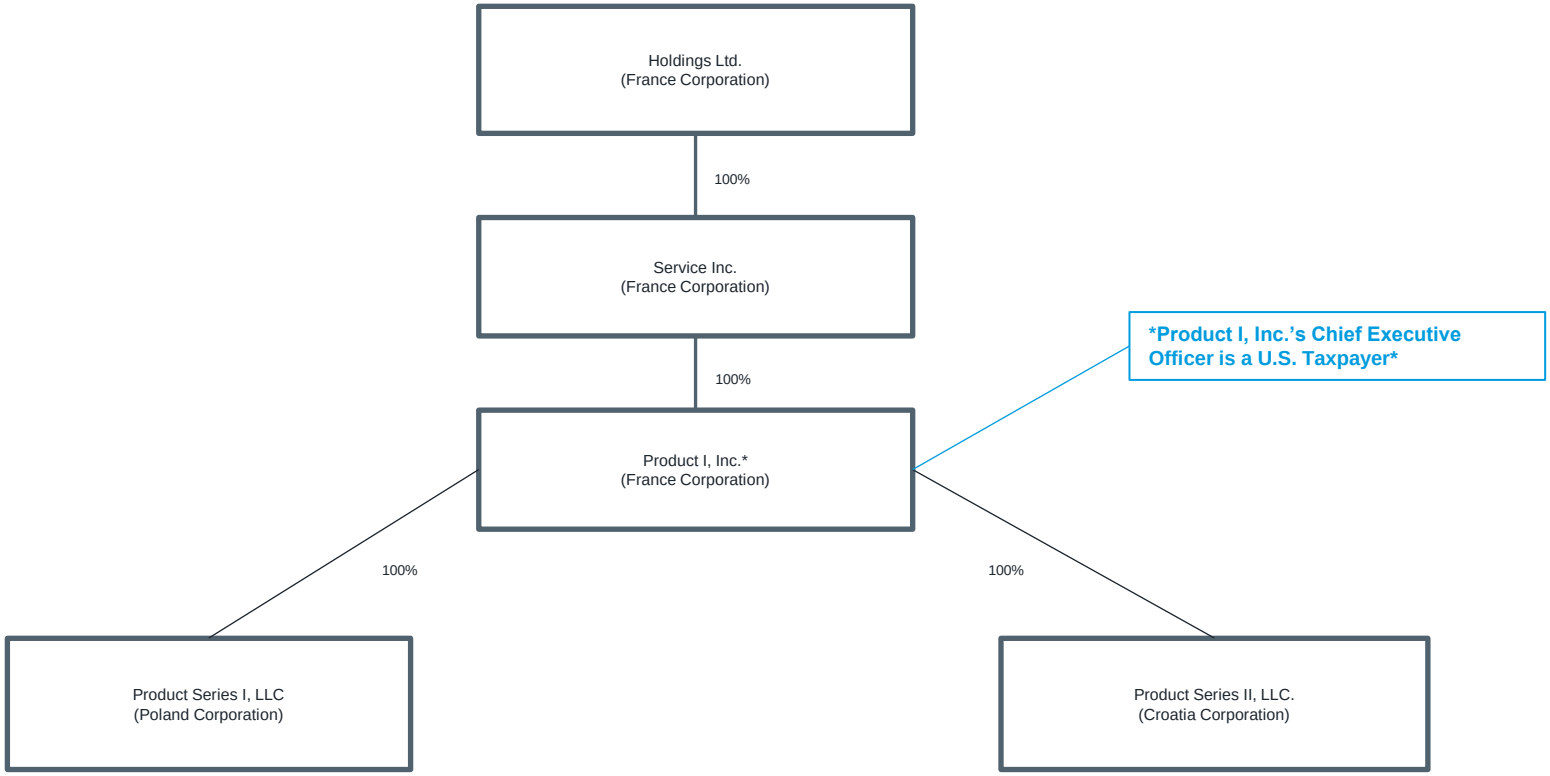
Example Two


Limited Partners
Fund GP, LLC (Delaware LLC)
LP
Opportunity Fund GP, L.P. (Delaware LP)
GP
Other Limited Partners
Rollover, L.P.
GP
GP
LP
~75%%
LP
~25%
GP
Fund Series I (Delaware Series)
Co-Investment, LP (Delaware LP)
LP
~50%
LP
~50%
Aggregator LP (Delaware LP)
100 %
Holdings Ltd. (Canadian Corporation)
100%
Products Inc. (Canadian Corporation)
100%
100%
100%
100%
Product I, Inc. (Delaware Corporation)
Product II, Inc. (Canadian Corporation)
Product III, Inc. (Canadian Corporation)
Product IV, Inc. (Canadian Corporation)
100%
100%
Series Product I, Inc. (Delaware Corporation)
Series Product II, Inc. (Delaware Corporation)

Example Three



Example Four



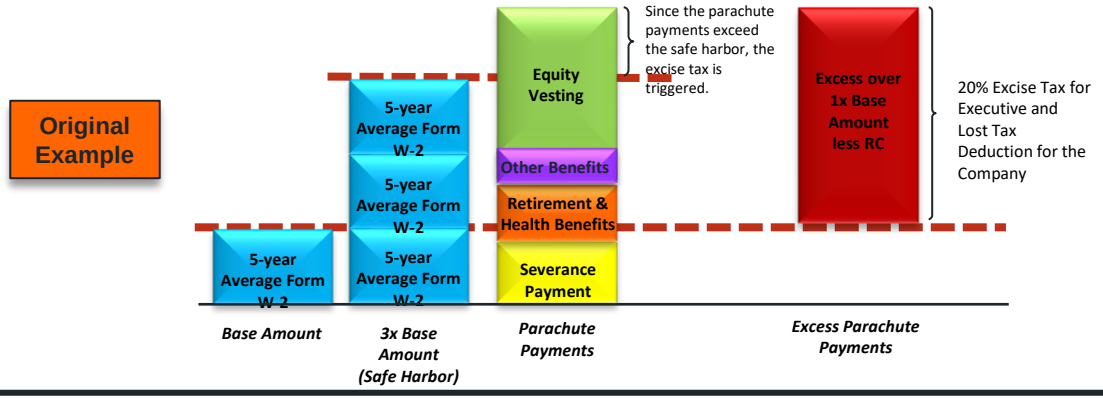
Public Company Mitigation Strategies

- Timing Strategy
  - Identify potential “disqualified individuals”.
  - Determine the best approaches to adjust compensation for the identified potential disqualified individuals.
- Non-Compete
  - Attribute non-compete value to below the line calculations for Section 280G analysis; it is very important to include compensation consultants in this analysis.
  - This relates to the exception from 280G for reasonable compensation for services rendered prior to the CIC.
- Reduction of excess parachute payment by reasonable compensation for services rendered prior to the CIC.
- The foregoing approaches require significant lead time and advanced planning to successfully facilitate.

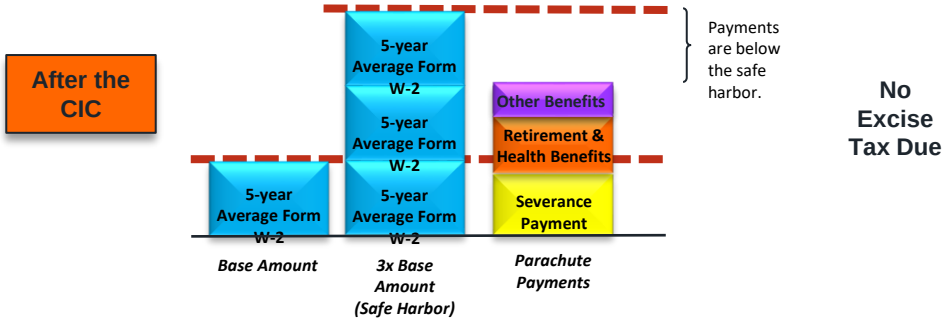
Reasonable Compensation for Services Performed after a Change in Control

- Payments can be restructured so that the amount payable may be considered “reasonable compensation” for services actually performed after a change in control.
  - Compensation for agreeing to a covenant not to compete.
    - Legally Enforceable
    - IRS Position: “***Lesser of***”
- Economic Loss
- Reasonable Compensation
  - If a “transition period” is required in the agreement, compensation which is reasonable for services performed after change in control is excluded from the calculation.
    - “Stay Pay”
    - Retention Bonuses

Reasonable Compensation for Services Performed after a Change in Control



Assume the Equity Awards were Reasonable Compensation for Services Rendered….



No Excise Tax Due

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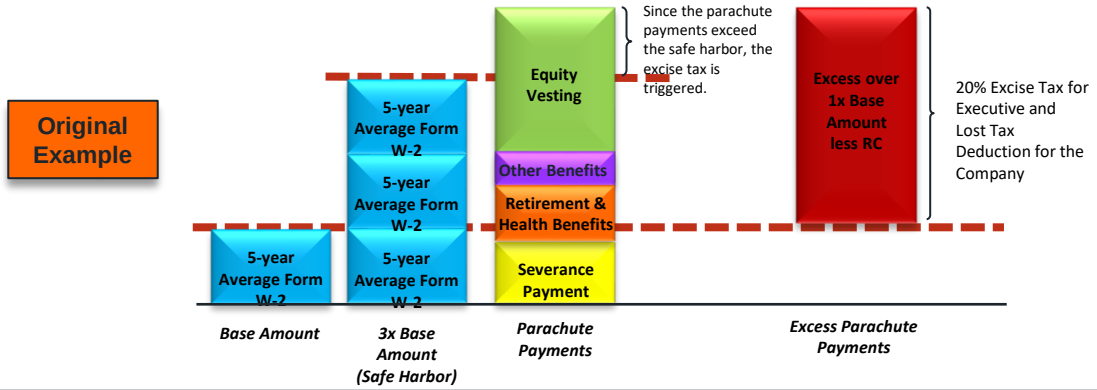
Valuation - Non-Compete Agreement ("NCA")

- Revenue Ruling 77-403 states that the valuation analyses should address three key concerns:
  - Whether, in the absence of the covenant, the covenantor would desire to compete with the covenantee.
  - The ability of the covenantor to compete effectively with the covenantee in the activity in question.
  - The feasibility, in view of the activity and market in question, of effective competition by the covenantor within the time and area specified in the covenant.
- Value of NCA is typically limited to the lesser of:
  - Amount of economic loss if the individual were to compete; or
  - Level of reasonable compensation individual could have earned during the restricted period.

Reasonable Compensation for Services Rendered Prior to Change in Control

- "Reasonable compensation" for services rendered prior to the change in control
  - Such payments are still treated as parachute payments.
  - However, in determining the excess parachute payments, the amount of such payment that is for reasonable compensation can be subtracted from the value of the excess parachute payments.
  - Services must actually be rendered and the payment must be reasonable compensation.
- Reasonable compensation determination
  - Facts and circumstances test based on relevant factors including:
    - Nature of services rendered;
    - Individual's historic compensation for performing such services; or
    - Compensation of individuals performing comparable services in situations where compensation is not contingent on a CIC.
- Application
  - Long-Term Incentive Awards.
  - Annual Bonus Arrangements.

Reasonable Compensation for Services Rendered Prior to Change in Control



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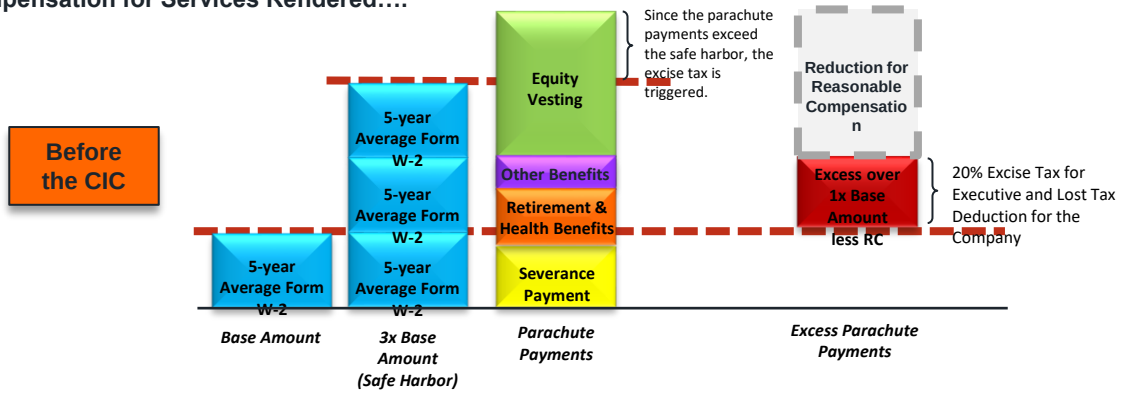

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Private Company Mitigation

- There are three main approaches to avoiding or mitigating Section 280G or Section 4999 liability in private company transactions:
  - Relying on upon the shareholder vote exception;
  - Reducing amounts payable to the disqualified individual to one dollar less than the amount that would trigger the excise tax, a “Cut-Back”; or
  - “grossing-up” the payments so that the disqualified individual retains the same amount in payments as if Section 4999 never applied.

Shareholder Approval Exception to Sections 280G and 4999

- For private companies, payments are exempt from the definition of “parachute payment” if paid with respect to a non-publicly traded corporation and if the shareholder approval requirements are met.

Necessary Shareholder Waiver Documents

- Parachute Payment Waiver
  - Signed by each disqualified individual;
  - Waiver provides that a disqualified individual waives all excess parachute payments that would be payable as a result of the transaction, regardless of whether the shareholders approve the excess parachute payments or deny them;
  - Waiver cannot be contingent on shareholder approval; and
  - Need “daylight” between the signature of the waiver and the shareholder approval.

Necessary Shareholder Waiver Documents

- Under the shareholder exception payments must be approved by 75% of the shareholders entitled to vote immediately before the change in ownership (normal voting rules of the corporation apply).
  - This “look-through” rule to Section 280G applies if:
    - (1) the Entity Shareholder’s stock holdings comprise at least one-third of the Entity Shareholder’s total assets (determined per the Asset Test); and
    - (2) the Entity Shareholder owns 1% or more of FMV of the corporation’s stock.
  - Adequate disclosure to all shareholders entitled to vote is required.
  - Neither the Company nor any member of the “control group” undergoing the change of control or its controlled group **cannot** be publicly-traded.
    - **Note**: “publicly-traded” here refers to any publicly traded company, publicly held or listed company whose ownership is organized through freely traded shares of stock over public markets.

Equity Compensation Valuation Issues

- Generally, the full value of payments are considered Parachute Payments.
- Q/A-24(c) Time-Based Exception:
  - Only a portion of a payment may be considered a parachute payment.
  - Payments must be:
    - Substantially certain to be made if DI continues to provide services; and
    - Related, at least in part, to services performed prior to the CIC.
- Acceleration in vesting and payment (ex. options, deferred compensation, etc.).

24(c) Value = PV Acceleration + Lapse of Obligation

PV Acceleration = Payment less PV of payment

Lapse of Obligation = 1% of payment for each calendar month

Example

- Facts and assumptions:
  - 10,000 shares of restricted stock vest on the third anniversary of grant (subject to the achievement of specified performance goals in the case of performance-based restricted stock).
  - 26 months into the vesting period, the company undergoes a CIC, and the restricted shares become fully vested and are cashed out at $30 per share.

Time-based restricted stock	Performance-based restricted stock
Cash value of non-vested stock: - 10,000 shares x $30 / share = $300,000 - LSO months = 10 - Parachute value = 600 + (1% x 10 LSO months x cash value) **Parachute value: $30,600**	Cash value of non-vested stock: - 10,000 shares x $30 / share = $300,000 - Parachute value = cash value **Parachute value: $300,000**

Common Problem Areas

- In some cases, equity may appear to be vested, however, the various agreements governing the equity cause it to be treated as unvested until the CIC actually occurs.
- In these situations, the full value would be treated as a parachute payment—Q/A-24(c) would not apply.
  - Examples:
    - Punitive Repurchase Provisions
      - If employee leaves voluntarily, shares are forfeited (or the company may repurchase the shares at lesser of cost or current FMV).
    - Hidden Performance Conditions
      - Agreement provides that vesting of time-based award will be accelerated upon a CIC “if the employee has otherwise performed his or job duties satisfactorily.”

Common problem areas

- Other Areas:
  - New Employment Agreements.
    - Base Pay and Bonus Increases—treat at parachute payment (if SH vote is possible); otherwise rely on reasonable compensation exception.
- Agreements entered into within 12 months prior to a CIC—presumed contingent on CIC but may be rebutted with clear and convincing evidence
  - Examples:
    - Stock options;
    - Stock grants (vested or unvested);
    - Changes in compensation; or
    - Retention Payments.
  - Result if presumption stands is that they are “all in” even if previously vested, or would otherwise be only partially included under Q/A-24(c).
- REMEMBER: 280G can continue to cause problems years after a transaction is completed.

Cutbacks, Gross Ups and Net Better Cutback Exceptions

- A “cutback” provision in a compensation arrangement provides that payments made to an executive may not exceed (and thus may be reduced) to a specified threshold (often $1.00) below the disqualified individual’s Safe Harbor value.
- A “gross up” will result in the corporation paying not only the excise tax owed by the disqualified individual, but also the income and excise taxes attributable to the make-whole payments, which themselves constitute taxable income to the disqualified individual. In addition, the) corporation bears the costs of the lost corporate tax deduction for the excess parachute payments (including gross-up payments).
- Under a “net-better” cutback, a disqualified individual’s payments are reduced to an amount below the disqualified individual’s Safe Harbor only if the reduction results in greater after-tax proceeds to the disqualified individual compared to if there were no reduction and the disqualified individual bore full responsibility for payment of the excise tax.