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Compensation Tax Issues in M&A: How IRS Rules Affecting Compensation Arrangements Can Impact Your Transaction

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EXECUTIVE COMPENSATION TAX ISSUES IN CORPORATE M&A TRANSACTIONS

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OVERVIEW

- Identification of Key Tax Provisions
- Understanding the Business Context – Identifying Issues and the Achieving the Desired Outcome
- Special Situations

IDENTIFYING KEY TAX PROVISIONS

1. 280G
2. 409A
3. 162(m)

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Code Section 280G

“Golden Parachute” Provisions

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OVERVIEW OF CODE SECTION 280G

- In general, Section 280G of the Internal Revenue Code provides that no deduction is allowed to a corporation for “excess parachute payments,” and Section 4999 of the Code imposes an excise tax on the recipient of any excess parachute payment in an amount equal to 20% of the amount of such excess parachute payments.
- A "parachute payment" is generally any payment made to a “disqualified individual” that is contingent on or related to a change in control, including, for example, severance benefits (whether or not denominated as “change in control” severance benefits) and non-cash compensation such as the accelerated vesting of equity-based awards.

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OVERVIEW OF CODE SECTION 280G

- A “disqualified individual” subject to the golden parachute rules is any individual who is an employee or other service provider of the corporation undergoing the change in control and who is also an officer, a highly compensated individual or a shareholder owning a significant amount of the corporation’s outstanding shares of stock (i.e., stock with a fair market value exceeding 1% of the fair market value of the outstanding shares of all classes of the corporation’s stock).
- The starting point of the golden parachute calculations is to calculate the disqualified individual’s “base amount”. The base amount is generally the average of the disqualified individual’s W-2 compensation for the 5 calendar years preceding the year in which the change in control transaction closes. The disqualified individual’s “safe harbor” amount is equal to 3 times the executive’s base amount less $1.

OVERVIEW OF CODE SECTION 280G

- If the executive's total parachute payments are equal to or less than the safe harbor amount, then the golden parachute rules do not apply and there is no excise tax or loss of deduction. However, if the parachute payments exceed the safe harbor amount, then the amount by which the parachute payments exceed the base amount will be subject to the excise tax and disallowance of deduction.
- For example, if an executive has a base amount of $100,000, parachute payments of up to $299,999 will not be subject to the excise tax or the disallowance of deduction, but a parachute payment of $300,000 (only $1 more) will be subject to those rules to the extent of $200,000. Note that because of this treatment, an individual entitled to parachute payments only slightly in excess of his or her safe harbor amount may be in a better after-tax position if his or her payments are automatically reduced to the safe harbor amount. In the above example, the individual avoids an excise tax of $40,000 (20% of the $200,000 excess parachute payment) merely by having his or her payments reduced by $1.

OVERVIEW OF CODE SECTION 280G

- Due to the potential magnitude of Section 280G-related liabilities – and their economic impact on individuals and corporations involved in transaction, it is crucial to identify and quantify these liabilities early in the life span of a transaction
- Look for:
  - Payments made as a result of the transaction (e.g., deal bonuses)
  - Vesting occurring as a result of the transaction (change in control vesting of equity compensation)
  - Payments or vesting that may occur in connection with the transaction (e.g., severance or equity vesting on a qualifying termination of employment following the transaction)
  - Gross-up provisions (designed to make an executive whole economically despite the imposition of the 4999 excise tax

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SECTION 409A

Non-Qualified Deferred Compensation

OVERVIEW OF CODE SECTION 409A

- **Review of Section 409A**
  - Section 409A of the Internal Revenue Code governs the timing of elections to defer compensation, the timing of distributions of deferred compensation and the reporting and taxation of deferred compensation.
  - Amounts are generally considered to be deferred if an individual obtains a legally binding right in one tax year to receive compensation in a later tax year.
  - A violation of Section 409A may result in immediate inclusion in income of the vested deferred amounts and penalty taxes and interest to the employee and may also result in penalties for reporting and withholding violations by the service recipient company.

OVERVIEW OF SECTION 409A

- Section 409A can apply not only to traditional deferred compensation arrangements, but also to other types of compensation, including:
  - Equity and equity based compensation
  - Transaction and deal bonuses
  - Severance payments and benefits
- It is not uncommon for compensation arrangements to run afoul of 409A rules and this can have significant economic impact on employees involved in a transaction.
    - Due to complexity and broad reach of 409A coverage, beware of compensation arrangements which may have been drafted in a way that violates 409A rules

OVERVIEW OF CODE SECTION 409A

- In the context of an M&A transaction, primary concerns raised by 409A are:
  - Identification of potential existing 409A problems with the deferred compensation arrangements existing at the target company (e.g., impermissible payment events, failure to include required provisions such as a six-month delay)
  - Ensuring that the desired business outcome with respect to compensation arrangements can be accomplished without creating 409A violations
- In very general terms, this means a two-step analysis:
  - Determine to what extent compensation arrangements are subject to 409A
  - Determine if existing terms comply with 409A and whether desired treatment in the transaction is permissible under 409A

Other Potentially Important Tax Provisions

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OTHER SIGNIFICANT TAX PROVISIONS

- Section 162(m) generally limits to $1M the deductibility of compensation paid to certain of a public corporation's executive officers
  - Although the exception from this limitation for "qualified performance-based compensation" has been eliminated, older arrangements may qualify for grandfathering protection and it is important to identify these and avoid inadvertently losing the grandfathering protection
  - Acquirors may wish to understand the extent to which compensation payable pursuant to inherited compensation arrangements will be deductible in the future

OTHER SIGNIFICANT TAX PROVISIONS

- Section 424 of the Code (and related provisions of Section 409A) contain rules which govern the manner in which stock options may be assumed ("rolled over") in a transaction without resulting in adverse tax consequences and should be consulted in situations where such a rollover is contemplated

PLANNING THE TRANSACTION

- In order to properly structure a transaction, the practitioner will need to understand:
  - What compensation arrangements are in place
  - Whether there are existing issues with those arrangements
  - What effect will the transaction have on the arrangements
  - What is the desired business outcome for the arrangements

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PLANNING THE TRANSACTION - DILIGENCE

- As part of the diligence process, practitioners need to identify and understand the compensation arrangements affected by the transaction. Common types of arrangements which can require special attention from a tax perspective are:
  - Equity and equity-based compensation
  - Severance and change in control protections
  - Deferred compensation
  - Transactional-related or deal bonuses
- Any of the arrangements described above could implicate 280G and/or 409A and should be considered from both perspectives

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EQUITY COMPENSATION

- **The most common types of awards that may be outstanding at target include:**
  - Stock options: A right to purchase shares of company stock at a specified price, generally referred to as the "exercise price"
  - Stock appreciation rights (SARs): A right to receive a cash payment based on the excess, if any, of the value of company common stock on the exercise date over the value of the stock on the grant date
  - Restricted stock: Grant of shares of company stock subject to vesting restrictions
  - Restricted stock units (RSUs): The right to receive a share of stock (or cash value of a share of stock) upon vesting or a later date

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EQUITY COMPENSATION – 409A ISSUE SPOTTING

- When reviewing equity compensation arrangements, look for:
  - Evidence that stock options were not granted with an exercise price less than the fair market value of the shares at the time of grant
  - Stock options are generally exempt from 409A, but not if they are in-the money at grant
  - Especially important in private companies where valuation may not be easy and 409A rules may not be familiar – look for contemporaneous valuation reports
  - Failure to be exempt probably means a 409A violation – generally taxation of spread in year of vesting – including additional 20% tax due to violation of 409A

EQUITY COMPENSATION – 409A ISSUE SPOTTING

- When reviewing equity compensation, look for restricted stock units that do not pay out immediately upon vesting (e.g., RSUs which pay out if the holder retires after reaching certain eligibility criteria)
  - These RSUs may not be exempt from Section 409A as short-term deferrals
  - 409A compliance concerns could limit the ability to determine the timing of the payment of such awards (6 month delay)

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EQUITY AND OTHER COMPENSATION – 280G ISSUE SPOTTING

- In reviewing equity and other compensation arrangements, also look for:
  - Provisions accelerating vesting on a ‘single trigger’ (i.e., upon the deal) or ‘’double trigger’ (upon certain terminations of employment in connection with the deal) basis
  - Accelerated vesting has a value and can be a parachute payment, potentially subject to the excise tax and deductions limitation provisions of Code Sections 280G and 4999
- Accelerated vesting and payment of other compensation can also implicate 280G/4999 – look for
  - Deal bonuses
  - Severance payments and benefits
  - Any payment made pursuant to an agreement entered into within one year before a change in control is presumed (rebuttable) to be contingent on that change in control, i.e., parachute payments

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ISSUE SPOTTING

- If a company has deferred compensation that provides for payment on a change in control, check to see if the definition aligns with the change in control definitions contained in 409A
  - 409A permits payment of deferred compensation upon a change in control, but the transaction must be a change in control under the definitions contained in the 409A regulations
- Practitioners will be asked to assist in quantifying the scope of actual and potential issues discovered in diligence, including:
  - Assessing the amount of potential 280G-related liabilities and their impact on transaction participants
    - 280G liabilities are often difficult to pin down, due to reliance on assumptions such as the timing of closing and whether or not an individual will receive severance – different fact patterns can yield very different results
    - The value attributed to accelerated vesting for 280G purposes is governed by special (and complex) rules
  - Assessing any 409A violations and identifying whether they can be fixed or how they can be dealt with
    - A Good Reason definition that gives the individual too much flexibility to determine the timing of triggering severance may subject the agreement to Section 409A

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PUTTING THE DILIGENCE IN CONTEXT

- Understand the deal structure (merger, stock purchase, asset purchase) and business considerations – especially with respect to equity compensation
  - In mergers or stock acquisitions, outstanding equity awards are usually assumed/substituted although sometimes may be cashed out/canceled
  - In an asset transaction, outstanding awards generally remain subject to the seller's equity plan, and there is a termination of employment of seller's employees for purposes of equity plan
  - Buyers need to understand not only the desired treatment but what is permissible or achievable under the plans/agreements

EQUITY TREATMENT – GENERAL CONSIDERATIONS

Considerations for determining treatment of equity awards:

- business decisions/use of cash
- dilution of acquiror's shareholders
- prevalence of out-of-the-money options
- ability to achieve retention benefits through continuation of awards
- terms of the applicable equity compensation plans
- legal compliance issues raised in diligence
- legal limitations (e.g., consent requirements, substitution limitations)
- <u>Section 280G golden parachutes and potential gross-ups</u>
- administrative burden considerations: equity tracking, employee communications, accounting, SEC registration
- international compliance

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EQUITY TREATMENT – TAX CONSIDERATIONS

- Cash out of options and SARs generally do not violate Section 409A
  - Canceling stock options and SARs in exchange for an immediate cash payment that is equal to the excess of the per share transaction price over the applicable exercise price should not violate Section 409A
  - Earnouts and escrows should be structured to comply with Section 409A
  - Section 409A provides an exemption for "earnout" payments or payments otherwise held back from payment upon closing, so long as the earn-out is paid on the same schedule and on the same terms and conditions as payments are made to target shareholders generally and the amount is paid out fully <u>within five years</u> after the change of control

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EQUITY TREATMENT – TAX CONSIDERATIONS

- Assumption of options and SARs must be structured to preserve the aggregate spread in order to comply with Section 409A
  - Assumed awards are usually not exchanged on a 1:1 basis in shares of the acquiror; rather, an exchange ratio is used to adjust the awards.
  - Options and SARs may generally be exchanged and adjusted for equivalent rights in a transaction and will not violate Section 409A so long as the aggregate spread on the options or SARs is not increased.

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EQUITY TREATMENT – TAX CONSIDERATIONS

- **"Rollover" of options/SARs**
  - Consider both ISO and 409A rules, which are very similar
  - Options may be "in the money" immediately after closing and exempt from Section 409A and comply with the ISO rules if the rollover would comply with Section 424 (i.e., no increase in the aggregate value of the spread or the per share ratio of exercise price to share price)
  - Transaction must be a "corporate transaction" (as defined in Reg. § 1.424-1(a)(3))
    - A corporate merger, consolidation, acquisition of property or stock, separation, reorganization or liquidation
    - A distribution (excluding ordinary dividends) or change in terms in number of outstanding shares
    - Conversion is permitted in a spin-off but not a carve-out IPO

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EQUITY TREATMENT – TAX CONSIDERATIONS

- The Section 409A exchange ratio test is similar to the ISO rules but more permissive
- The Section 409A test is satisfied if the ratio of the exercise price to the fair market value of a share subject to the option immediately after the assumption or substitution is not greater than the ratio of the exercise price to the fair market value of a share subject to the option immediately before the assumption or substitution
  - Like the ISO rules, the Section 409A rules require that the aggregate spread value not be increased
  - But Section 409A allows an acquiror to “de-leverage” the equity position of employees by lowering the ratio of exercise price to stock value and thus rollover with respect to fewer shares

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EQUITY TREATMENT – OTHER TAX CONSIDERATIONS

- **RSUs and Section 409A**
  - RSUs are subject to Section 409A unless there is an applicable exemption (e.g., short-term deferral where the RSUs are settled at, or within a limited period following, vesting)
  - Typically, where unvested RSUs are being assumed pursuant to the same vesting terms or cashed out in a transaction, such treatment does not violate Section 409A
- **Restricted Stock**
  - Participants may have made 83(b) elections to be taxed at grant, rather than at vesting
  - If transaction results in a vesting event, make sure that documentation exists for 83(b) elections, to support position that vesting does not result in taxation

DEALING WITH GOLDEN PARACHUTE ISSUES

- Employment arrangements may include one of the following types of provisions relating to Section 280G (or may be silent):
  - Haircut provision: payments must be reduced to a level that would not trigger the excise tax
  - Better-of provision: payments are cut back to a level that would not trigger the excise tax unless the individual would be in a better economic position (on an after-tax basis) in receiving all amounts and simply paying the excise tax
    - Agreements that are silent on 280G treatment can be viewed as effectively incorporating this provision
  - Gross-up provision: an additional payment to the individual to make the individual whole for any excise tax triggered by excess parachute payments
    - Beware potential large liabilities associated with gross-ups – as gross up payments are themselves parachute payments (e.g., subject to the excise tax)

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DEALING WITH GOLDEN PARACHUTE ISSUES

- First step should be quantifying (really estimating) 280G and related (e.g., gross-up) liabilities
  - Beware of the potential impact of “gross-up” provisions
- Once an estimate is available, determine if the potential liabilities may be material to the companies or key participants – such as members of the executive team
- Keep an eye out for planning/mitigation opportunities
  - Early calendar year closing may allow payments in the prior calendar year which will increase the recipient’s base amount and thereby decrease the potential parachute tax liabilities)
  - “Cleansing Vote” may be possible if target is not public

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280G – PRIVATE COMPANY EXCEPTION

- Private company shareholder approval exemption – a change in control-related payment will not be a parachute payment if shareholder approval of the payment is obtained in accordance with the rules
  - 75% of the shares entitled to vote (on a date within six months before the change in control) must approve the payment
    - Shares held by executives whose payment is subject to the vote may not vote their shares
  - Adequate disclosure of all material facts concerning all parachute payments must be made to *all* shareholders (include individual quantification)
  - The vote must determine the right of the individual to receive or retain the payment (no agreement to pay anyway)
  - The vote must be separate from the shareholder vote to approve the transaction

280G – PRIVATE COMPANY EXCEPTION

- 280G “Cleansing Vote” intended to take advantage of this exception
- May involve waiver of entitlements, which are reinstated only if the requisite shareholder vote is obtained
- Requires education of executives and their consent to the waiver
- Beware of sensitivities surrounding adequate disclosure of all material facts to <u>all</u> shareholders

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SPECIAL SITUATIONS - OPTION ROLLOVER WITH ESCROW

Escrows and earn-outs may raise special concerns as to the value on which the rollover occurs

Example:

- Target is being acquired for $10 per share in cash
- 20% of the purchase price is being placed in an escrow as security for Acquiror’s claims for any breaches of target representations and warranties
- Acquiror’s stock is trading at $20 per share
- Acquiror is assuming outstanding target options and substituting Acquiror’s stock for target stock

SPECIAL SITUATIONS - OPTION TREATMENT - ESCROW

- To comply with Reg. § 1.409A-1(b)(5)(v)(D), the option exchange ratio must not increase the aggregate spread in the option being assumed
- For purposes of applying this test, should target stock be valued at:
  - $10 per share?
  - $8 per share?
  - Somewhere in between?

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SPECIAL SITUATIONS - OPTION TREATMENT - ESCROW

- There are several schools of thought on how to answer this question:
  - We never had to worry about escrows for ISO purposes under Section 424(a), why start now? -- use $10 per share
  - Section 409A is a whole new ballgame so better safe than sorry – use $8 per share
    - This could be coupled with a cash payment when and if the escrow is paid
  - It is a question of fact not law – get an appraisal
  - Appraisal would not necessarily be a typical valuation exercise; rather it would involve risk analysis as to likelihood of indemnities being triggered
- This should be an issue only with private target companies
- In addition, remember that any payments from the escrow/earn-out payments made to former holders of options, restricted stock, RSUs, SARs, etc. will be taxed as ordinary income (and not as capital gain) upon receipt and will also be subject to withholding taxes

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SPECIAL SITUATIONS - TERMINATING DEFERRED COMPENSATION PLANS

- If Company has deferred compensation subject to 409A, can you pay out at the CIC if not provided for in the document?
- Section 409A permits the termination of an NQDC plan within the 30 days preceding or the 12 months following a change in control event but only if all aggregated plans, agreements, etc. sponsored by the company immediately after the change in control event that apply to each participant experiencing the change in control event are terminated
  - Action to be taken by the service recipient that is primarily liable immediately after the transaction for the payment of the NQDC
  - Balances must be paid under all aggregated plans within 12 months of the date the service recipient takes the action to terminate the plan
  - For aggregation, these types of plans are generally "account balance" or "non-account balance" plans for purposes of Section 409A

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SPECIAL SITUATIONS - 162(m) AND GRANDFATHERING

- The tax reform of December 2017 generally ended the performance based compensation exception from the 162(m) $1 million cap on deductible compensation that existed under prior law.
- The law however included a transition rule that would exempt compensation paid under "written binding contracts" that were in place as of November 2, 2017, provided such contracts are not materially modified after that date – so-called "grandfathering." Practitioners may be asked to assess whether the compensation arrangements in place at a publicly-traded target qualify for such grandfathering.
- This analysis should include an examination of whether the existence of discretion or an amendment right under a contract could cause it not to be viewed as a binding contract.
- Because of the wording of the provision, an analysis of the obligation under applicable state contract law may be required.

SPECIAL SITUATIONS – POST-CLOSING

- Section 409A may limit the ability convert severance arrangements into new consulting, retention or non-competition arrangements
- Substitution rules – Any amount, or entitlement to any amount that acts as a substitute for, or replacement of, NQDC amount constitutes a payment of NQDC under Section 409A
- For target counsel, consider conducting 409A delay analysis
  - Special M&A rules for determining specified employees
  - Could impact the payment timing of severance benefits for qualifying terminations of employment following the transaction

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Mr. Nelson has represented both purchasers and sellers in a wide variety of corporate transactions, including mergers, asset sales, stock purchases and spin-offs. He has advised clients with respect to potential impact of “golden parachute” termination agreements, permissible treatment of employee stock options and structure of retention and deal bonus arrangements.

Mr. Nelson frequently conducts reviews of corporate compensation programs to identify and correct change in control-related deficiencies in such arrangements, and has assisted publicly traded clients in the preparation of required executive compensation disclosure.

Mr. Nelson has advised a wide range of clients, including Gilead Sciences, Inc., WeWork Companies Inc. and Biogen, Inc.

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Gavin A. White advises clients on a wide variety of U.S. and international tax matters, including public and private acquisitions, divestitures, bankruptcy reorganizations, equity and debt offerings, and joint ventures. Mr. White serves as hiring partner for the New York office and is a member of the firm’s Diversity Committee.

Mr. White’s representative matters include: Sealed Air Corporation on its $3.2 billion sale of Diversey Care to Bain Capital; CBS Corporation (as special REIT tax counsel) in the spin-off and REIT conversion of its subsidiary, CBS Outdoor Americas Inc., and in the $644 million IPO of common stock of CBS Outdoor Americas; News Corporation in its $950 million acquisition of Move, Inc.; Joh. A. Benckiser GmbH, a holding company based in Germany, as the lead investor in its US$9.8 billion acquisition of D.E. Master Blenders 1753 N.V. (the Netherlands), a coffee and tea producer; Danaher Corporation in its $13.8 billion acquisition of Pall Corporation, and in the US$2.6 billion merger of its communications business with NetScout Systems, Inc.; Permira Funds (United Kingdom) in the $3.5 billion sale of its portfolio company, Arysta LifeScience Limited (Ireland), to Platform Specialty Products Corporation, and in the $2.8 billion sale of its portfolio company Iglo Foods Holdings Limited (United Kingdom) to Nomad Holdings Limited (British Virgin Islands); Longview Asset Management, LLC in connection with the $8.7 billion acquisition of PetSmart, Inc. by a consortium led by BC Partners (United Kingdom); Freescale Semiconductor, Ltd. and a private equity consortium, including The Blackstone Group L.P., The Carlyle Group LP, Permira Funds (United Kingdom) and TPG Capital, L.P., in Freescale’s $11.8 billion acquisition by NXP Semiconductors NV (the Netherlands); and NXP Semiconductors N.V. on its $47 billion acquisition by Qualcomm Incorporated.