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IRS Issues Long-Awaited Proposed Regulations on Golden Parachute Payments

Overview

On February 19, 2002, the Internal Revenue Service ("IRS") proposed new regulations[1] to Section 280G of the Internal Revenue Code (IRC). The new regulations provide amendments and clarifications to the proposed regulations issued on May 5, 1989, and would apply to so-called golden parachutes, i.e., any payments that are contingent on a change in ownership or control, occurring on or after January 1, 2004. In the interim period, taxpayers may rely on either the new regulations or those proposed in 1989.

Background

As a refresher, the following is a brief, general summary of the golden parachute law under IRC Section 280G:

If the total of the compensatory payments a "disqualified individual" receives as a result of a change in ownership or control equal or exceed three times the individual's average annual W-2 compensation over the preceding five years (the "base amount"), the payments are considered to be parachute payments. It is not necessary for the individual's employment to have terminated. If they do equal or exceed this threshold, then to the extent the individual's parachute payments exceed the greater of (i) one times the base amount or (ii) the amount of the payments considered reasonable for services already rendered, the payments will be considered to be excess parachute payments. Excess parachute payments are not deductible by the corporation and are subject to a 20% excise tax[2] payable by the individual.

Proposed Regulations

A summary of the amendments under the new regulations follows. See **Attachment A** for a summary table comparing the significant amendments under the new proposed regulations with those proposed in 1989.

- Disqualified Individuals:

  — A "disqualified individual" is defined as anyone who (a) is an employee or independent contractor who performs personal services for a corporation, and (b) is an officer, major shareholder, or a highly-compensated employee

1 **REG-209114-90**

2 IRC Section 4999 imposes a 20-percent excise tax on the recipient of any excess parachute payment, although both are not contingent upon the other. For example, an individual may be subject to the 20-percent excise tax under section 4999 even though the payor is a foreign corporation not subject to U.S. income tax.

— The definition of a disqualified individual has been amended in two ways:

(1) Elimination of the $1 million (based on fair market value at any time during the determination period) corporate stock ownership threshold for purposes of determining a major shareholder

⇒ The new proposed regulations do affirm that shares underlying vested stock options, including those that vest upon a CIC, are counted for purposes of the remaining 1% test

(2) Provides that the annualized compensation limit is set to the amount used to determine a highly compensated individual for tax-qualified retirement plans under IRC Section 414(q) ($90,000 in 2002 and adjusted periodically for cost-of-living increases)

⇒ If the individual is an employee, the provision by which the employee is <u>also</u> a member of the group consisting of the lesser of the highest paid 1% of employees or the highest paid 250 employees to be considered a highly compensated individual is retained under the new regulations

— The new regulations also change the disqualified individual determination period to be simply the period twelve months preceding (and ending on) the date of the change in ownership or control of the corporation (CIC event)

- <u>Valuation of Stock Options and Restricted Stock</u>:

— The new regulations clarify that nonstatutory stock options (NQSOs) and statutory stock options for which Section 421 applies (ISOs) are treated in the same manner for purposes of Section 280G

— Although the new regulations retain from the 1989 proposal the intrinsic value (spread) method for determining the value of a stock option, the new regulations provide an alternative safe harbor approach based on the Black-Scholes option pricing model

⇒ The IRS concurrently issued **Revenue Procedure 2002-13**[3] which provides guidance for valuing stock options under the safe harbor Black-Scholes method

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[3] This revenue procedure is effective April 26, 2002. The safe harbor valuation method can be used only for options with a remaining term between 12 and 120 months and a "spread factor" (equal to FMV at CIC/exercise price – 1) of between –60% and 220%. Based on our inquiry, the IRS has informed us that it is considering adding a 6-month and perhaps a 3-month remaining option term column in future guidance.

— With respect to restricted stock, the new rules confirm that a Section 83(b) election[4] will be disregarded for valuation purposes and that the payment is generally considered made (or to be made) on the vesting date

— Note that once the value of the restricted stock or the stock option (under either option valuation method) is determined, the parachute payment is determined based on the present value of the accelerated benefit as calculated using the rules retained from the 1989 proposed regulations[5]

⇒ See **Attachment B** for an illustration of the calculation process for determining the parachute payment for unvested options under the safe harbor Black-Scholes method versus the spread method for unvested options

- Determination of a Change in Ownership or Control[6]:

— The new regulations clarify that in determining whether two or more persons acting as a group acquire more than 50% of the FMV or voting power of the corporation, an individual who owns stock in both corporations (overlapping shareholder) is treated as acting in a group with respect to the other shareholders only to the extent of stock ownership prior to the CIC

⇒ This rule applies without regard to the type of shareholder involved (i.e., individual or institutional shareholder such as a corporation, mutual fund or trust)

- Determination of a Payment as Contingent on Change:

— The new regulations clarify that a payment is contingent on a change in ownership or control if the payment would not have been made absent a CIC, even if the payment is also contingent upon a second event such as termination of employment within a period following a CIC

⇒ This covers a "double trigger" severance arrangement contingent upon the occurrence of both a CIC and a subsequent termination of employment

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4 Under the usual rule in IRC Section 83(b) for restricted property (e.g., restricted stock), income tax is postponed until the property is no longer subject to a substantial risk of forfeiture or the property is transferable. However, an employee may elect (through a Section 83(b) election) to be taxed in the year of transfer rather than waiting until the property restrictions lapse at vesting.

5 Under Q&A-24(c) of the 1989 proposed regulations, the portion of the payment that becomes vested as a result of acceleration under a CIC is the lesser of (1) the accelerated payment or (2) the sum of the (i) difference between the present value of the payment and the accelerated payment value and (ii) an additional amount reflecting the lapse of the obligation to perform future employment services (calculated as 1% of the accelerated payment for each full month of services no longer required to be performed).

6 Under Section 280G, a CIC of a corporation is deemed to occur (1) once any one person or group acquires ownership of more than 50% of either the voting stock or the value of all stock of the corporation or (2) if within a twelve-month period any one person or group acquires assets of the corporation that have a total fair market value equal to or more than one-third of the total fair market value of all of the corporation's assets.

— The new regulations also clarify that, as a general rule[7], the entire amount of the payment is contingent on the change of ownership or control, including the payment of amounts made under the following circumstances:

⇒ Amounts due under a severance arrangement[8] that would have been paid for services after the termination or CIC

➢ Since payments made pursuant to an agreement entered into after a CIC were generally not considered parachute payments under the 1989 proposed regulations, this clarification will substantially limit the benefit of converting severance payments into greater payments under a post-CIC employment agreement

⇒ Amounts payable only on the attainment of a performance goal or event other than the continued performance of services

- Determination of Reasonable Compensation:

— The new regulations clarify two issues with respect to "reasonable compensation"[9] for services performed after a CIC

(1) Clear and convincing evidence that a payment is reasonable compensation exists if the individual's annual compensation after the CIC is not significantly greater than such annual compensation before the CIC, provided that the individual's duties and responsibilities are similar

⇒ If such duties and responsibilities have changed then the evidence must demonstrate that the individual's compensation is not significantly greater than the compensation paid to persons performing comparable services

(2) Payments made under a non-compete agreement may also constitute reasonable compensation if the agreement substantially constrains the

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7 As provided in Q&A-24 of the 1989 proposed regulations.

8 Q&A-24(c) provides a special rule for compensation that normally vests based on continued employment service, but is accelerated upon a change in control. Under this rule, a parachute payment can be limited to a value based on the sum of (i) the amount by which the accelerated payment exceeds the present value of the payment based on its normal (i.e., absent a CIC) vesting or payment schedule plus (ii) an additional amount reflecting the lapse of the obligation to perform future employment services (calculated as 1% of the accelerated payment for each full month of services no longer required to be performed). Note that the new proposed regulations retain the treatment of unvested options and accelerated vesting of SERP benefits under Q&A-24(c) but no longer apply this treatment to payment of amounts made under an employment agreement on a termination of employment, or upon a CIC that, without regard to the change, would have been paid for the performance of services after the termination of employment or CIC, as applicable.

9 An excess parachute payment is reduced by any portion of the payment that constitutes reasonable compensation for services actually rendered prior to a CIC. Payments that are made after a CIC and are deemed to be reasonable compensation are exempt from inclusion as a parachute payment.

individual's ability to perform services and there is a reasonable likelihood that the agreement will be enforced

— Since the new proposed regulations make it more difficult for taxpayers to support payments made on the basis of reasonable compensation, parachute-limiting techniques such as the payment of higher amounts under a non-compete agreement may no longer be considered reasonable

- Determination of Excess Parachute Payments:

  — The new regulations modify the method for determining the present value of a parachute payment contingent on an uncertain future event or condition

    ⇒ If there is at least a 50% probability that a payment will be made, the entire present value should be included as a parachute payment

    ⇒ Conversely, if there is less than a 50% probability that a payment will be made, then the present value is not included

    ⇒ The new regulations contain additional guidance if the inclusion or exclusion of the payment at the time of the CIC was incorrect which may result in a need to reapply the 3-times-base-amount test

  — The new regulations also provide guidance on determining the present value of an obligation to provide health care coverage based on GAAP principles by projecting the cost of health care premiums

- Definition of a Corporation:

  — The new regulations clarify that the term corporation includes any entity described as a corporation in the IRC[10] including real estate investment trusts, corporations with mutual or cooperative ownership (i.e., a mutual insurance company), certain tax-exempt associations and certain foreign corporations

- Exemption for Private Companies:

  — The new regulations clarify several aspects of the shareholder approval requirements[11] and the process that must be met to exempt a payment made by a company in which stock is not readily tradable, including the following:

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10 Corporation is generally defined under IRC Section 7701(a)(3).

11 Under Section 280G, a shareholder approval vote is valid only if (1) it is a vote of more than 75% of the shareholders entitled to vote based on ownership immediately before the change in ownership or control, and (2) disclosure is made with respect to payments that would otherwise be considered parachute payments for an individual.

⇒ A new rule of administrative convenience that validates an affirmative shareholder vote that takes place within the 3-month period prior to the CIC

⇒ Clarification that it is permissible for all payments or only the portion of the payments (as long as all payments are disclosed) that would otherwise be considered as excess parachute payments to be subject to vote to satisfy shareholder approval requirements

⇒ Clarification that payments with respect to tax-exempt organizations are exempt if (1) the payment is made by a tax-exempt organization undergoing a CIC as defined under the new regulations and (2) the organization must meet this definition both immediately before and after a CIC

- <u>Payment of Tax under Section 4999:</u>

— The new regulations stipulate that the payment of the excise tax under Section 4999 must be made based on the amount calculated for purposes of determining excess parachute payments

⇒ Therefore, to the extent that there was an incorrect valuation made in determining excess parachute payments, the excise payment is also determined to be incorrect

— In general, the excise tax under Section 4999 is due at the time the payment is considered made. The new regulations clarify, with some exceptions, that a payment is generally considered made in the taxable year that it is included in the disqualified individual's gross income

⇒ Subject to certain restrictions, the new regulations permit certain payments to be treated as made in the year of the change of ownership and control

<u>Comments Requested</u>

Comments as well as requests to speak at a June 26, 2002 public hearing on the proposed regulations must be received by June 5, 2002.

<u>Discussion of Proposed Rules</u>

Since the new proposed regulations largely clarify rather than introduce new interpretations of the rules under Section 280G, we do not anticipate that the new proposed regulations will result in any significant changes to the contemporary designs of change in control agreements. However, in clarifying the determination for payments made contingent on a CIC and the determination of reasonable compensation, certain parachute mitigation techniques, such as the conversion of severance payments into greater payments under a post-CIC employment agreement, increased payments in exchange for a non-compete agreement, and paying retention bonuses with the ability to receive payment upon voluntary termination for "good reason" will be more difficult to support under the new proposed regulations.

By narrowing the definition of a disqualified individual, the IRS has made a favorable effort to exempt those individuals who may come in above the $1 million threshold simply due to the run-up in stocks during the 1990s, but who may not be among the most senior group of executives. Furthermore, the use of the Section 414(q) limit to determine a highly-compensated individual effectively provides a more favorable automatic indexing mechanism compared with a fixed dollar limit that inevitably becomes too low over time. Lastly, the effort to ease the administrative burden for certain corporations whose stock is not readily tradable in seeking to obtain shareholder approval to exempt potential parachute payments is also a favorable improvement.

However, in general, the use of the new safe harbor Black-Scholes method relative to the spread method would result in unfavorable additional tax liabilities for excess parachute payments if a corporation chooses to use this new method. The safe harbor Black-Scholes method will <u>always</u> result in a higher parachute payment because the Black-Scholes value reflects an option's intrinsic value (i.e., spread) at a minimum <u>plus</u> any remaining time value (i.e., the value for future stock price increases) that the option may have. In general, option values determined using the safe harbor Black-Scholes method relative to the spread method increase the greater the volatility, the longer the remaining option term and the smaller the option spread (see **<u>Attachment B</u>** for an illustration of the calculation process for determining the parachute payment for unvested options under the safe harbor Black-Scholes method versus the spread method).

Furthermore, options that are underwater (up to a spread factor of –60%) on the date of a CIC have a positive value if the proposed safe harbor Black-Scholes method is employed. This could potentially result in an excess parachute payment paid for an option that may never have value to an employee. Since the IRS has allowed for additional alternative valuation methods to be considered in future guidance, it will be interesting to see if a more attractive alternative is offered in the future.

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Specific questions concerning this topic should be addressed to appropriate tax counsel. General questions may be addressed to Robert Timmerman in our New York office at (212) 986-6330. Copies of this letter and other published material are available on our website at www.fwcook.com.

Attachment A

Summary Table of Significant Amendments

The table below compares the significant amendments under the new proposed regulations with those proposed in 1989.

Amendments	1989 Proposed Regulations	New Proposed Regulations
Disqualified Individual	• Shareholder determination based on stock ownership of the lesser of $1 million in FMV or 1% of the total FMV of all outstanding shares • Highly-compensated individual based on annualized compensation equal to at least $75,000 and if individual is an employee, a member of the group consisting of the lesser of the highest paid 1% of employees or the highest paid 250 employees • Individual determination period is the portion of the corporation's year ending on the date of the CIC event and the immediately preceding 12 months (with an option to use the corporation's calendar year or fiscal year)	• Shareholder determination based only on corporate stock ownership of 1% of the total FMV of all outstanding shares • Highly-compensated individual based on annualized compensation at least equal to the limit under IRC Section 414(q) ($90,000 in 2002) and if individual is an employee, a member of the group consisting of the lesser of the highest paid 1% of employees or the highest paid 250 employees • Individual determination period is simply the period 12 months prior to and ending on the date of the CIC event
Valuation of Stock Options	• Covers treatment of NQSOs only; ISOs reserved for future regulations • Based on intrinsic value (spread) method	• NQSOs and ISOs are treated in the same manner • Allows for a choice of existing intrinsic value method or safe harbor Black-Scholes method
*Exemption for Private Companies**	• All payments that would otherwise be considered parachute payments are subject to vote to satisfy shareholder approval requirements	• Allows for choice of having all payments or only a portion (as long as all payments are disclosed) of the payments that would otherwise be considered as excess parachute payments to be subject to vote to satisfy shareholder approval requirements

* For corporations in which no stock is readily tradable.

Attachment B

Illustration of Stock Option Valuation Under the Spread Method Versus Safe Harbor Black-Scholes Method

The illustration shown below assumes:

- 1,000 options
- exercise price of $10/share
- CIC stock price - $20/share
- volatility of .5
- remaining term of 60 months
- due to vest in 12 months

	Spread Method	Safe Harbor Black-Scholes
A. Value of option payment • *Note percent increase of the safe harbor Black-Scholes method versus the spread method = $12,740 / $10,000 – 1 = 27%*	• Value of option payment (**A.**) = 1,000 x ($20 - $10) = $10,000	• Spread factor = $20 / $10 – 1 = 100% • Black-Scholes value (as a percent of FMV) in IRS table based on a 100% spread factor, remaining term of 60 months (based on full term to expiration) and a volatility of 50% = 63.7% • Value of option payment **(A.)** = number of options multiplied by the FMV/share at CIC multiplied by the table value provided in Appendix of **IRS Revenue Procedure 2002-13 =** 1,000 x $20 x 63.7% = $12,740
B. Present value[12] (PV) of accelerated benefit	**B.** = $10,000 / ((1 + 0.032/12) ^ 12) = $10,000 / 1.0325 = $9,685	**B.** = $12,740 / ((1 + 0.032/12) ^ 12) = $12,740 / 1.0325 = $12,339
C. Difference between **A.** and **B.**	**C.** = $10,000 - $9,685 = $315	**C.** = $12,740 - $12,339 = $401
D. Lapse of service obligation (1% for each full month of service lapse)	**D.** = $10,000 x (0.01 x 12) = $1,200	**D.** = $12,740 x (0.01 x 12) = $1,529
E. Sum of **C.** and **D.**	**E.** = $315 + $1,200 = $1,515	**E.** = $401 + $1,529 = $1,930
F. Parachute payment is the lesser of **A.** and **E.**	**F.** = Lesser of $10,000 and $1,515 = $1,515	**F.** = Lesser of $12,740 and $1,930 = $1,930

12 The interest rate for determining the present value (3.20%) is based on **Revenue Ruling 2002-10** and is equal to 120% of the semiannual short-term applicable federal rate (short-term 120% AFR) for March 2002.