

A PRACTICAL APPROACH TO AVOIDING THE GOLDEN PARACHUTE EXCISE

March 2007

*Avi M. Lev*¹

Davis, Malm & D'Agostine, P.C.

1. Introduction

After three years of experience with the current tax regime pertaining to golden parachute payments, “best practices” have evolved that permit employers to maximize such payments within the regulatory limitations. Although the existing rules raise pragmatic challenges, effective techniques have been identified that can be used, both at hiring and when a change in control is anticipated, to protect negotiated parachute payments while avoiding severe tax costs.

Golden parachute payments typically comprise a package of cash bonuses that will be paid, stock rights that will vest, and other benefits that will be delivered in the event that a corporation undergoes a sale, merger, initial public offering, or other change in ownership or control (a “change in control” transaction). Such payments are mainly offered to chief executives and other key employees, both as an inducement to accept employment and as an incentive to encourage the employee’s cooperation in implementing a chosen exit strategy for the existing stockholders.

The size and form of golden parachute payments are greatly influenced by tax considerations, and in particular by the current federal regulations,² which date from August, 2003. Although employers routinely consider the tax impacts of executive compensation at the time of hiring, more challenging tax questions necessarily arise later, when a change in control transaction is contemplated. Proper resolution of these tax issues may be critical to closing the transaction, because both the cooperation of the executives and the avoidance of large tax costs are usually needed to make such deals viable.

2. Summary of the Regulatory Scheme

¹ Avi M. Lev is a Senior Tax Attorney with Davis, Malm & D'Agostine, P.C. in Boston, Massachusetts. He holds an LL.M. in Taxation, *valedictorian*, from the Boston University School of Law.

² Treas. Reg., § 1.280G-1, “Golden Parachute Payments” (hereinafter, “Regs.”). The regulations implement statutory provisions which became law in 1984. Section 280G of the Internal Revenue Code (“Code”) defines the locus of payments subject to sanctions and renders such payments non-deductible to the corporation. Code Section 4999 imposes a 20% excise on the recipient in respect of the payments sanctioned by Section 280G.

The current regulatory scheme is comprehensively covered in the available literature³ and its nuances will not be reviewed here. In summary, generally, payments by a corporation to certain employees⁴ that are both (i) compensatory in nature and (ii) contingent upon a change in control will be “parachute payments.”⁵ Such parachute payments are considered excessive to the extent that their total for any one employee is above the employee’s average annual salary (the “base amount”).⁶ Such “excess parachute payments” are both nondeductible to the corporation and subject to a 20% excise on the employee, but only if the total of the parachute payments equals or exceeds a “safe harbor” threshold equivalent to three times the employee’s base amount.⁷

3. The Two Principal Methods for Avoiding the Excise

For most employees otherwise subject to the statute, there are usually only two practical methods by which to avoid these draconian tax results.

The first method, which is available to all corporate employers, is to keep the total of all parachute payments to any one employee under the safe harbor threshold. This usually is accomplished by reducing or limiting the amount of payments that are contingent on a change in control (either at time of hiring or later), but it can also be accomplished by increasing salary or other vested payments so as to increase the base amount. Both techniques can be problematic because the dollar figures representing the total of the “parachute payments” and the “base amount” often cannot be determined with reasonable certainty.

The second method, which is available only to private⁸ corporations, is to obtain shareholder approval of the parachute payments, or at least of those parachute payments that are in excess of the safe harbor threshold. The procedural requirements for the approval are exacting and cumbersome. Moreover, a prerequisite for shareholder approval is that the parachute payment must be forfeited by the employee if not approved by the shareholders, even if the employee otherwise has a pre-existing vested interest in the payment.

³ See for example: (1) Dubitzky & Lev, “Private Corporations and the New Golden Parachute Regulations,” Compensation and Benefits Review, September/October, 2004; (2) Henever, “Golden Parachutes: Final Regs. Increase Parachute Penalties for Many Post-2003 Changes in Control,” Journal of Taxation, September, 2003; (3) Rizzi, “New Case Heightens Impact of Golden Parachute Rules on Corporate M&A Practice,” Corporate Taxation, January/February 2004; (4) Bittker & Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 64.5, “Golden Parachutes;” (5) Internal Revenue Service, “Golden Parachute Audit Techniques Guide,” February, 2005.

⁴ Generally, employees (and independent contractors) who are officers, highly-compensated individuals, or 1% shareholders are subject to the regulations. See Regs., Q/A-15.

⁵ Code, § 280G(b)(2); Regs., Q/A-2.

⁶ Code, § 280G(b)(1); Regs., Q/A-34.

⁷ Code, §§ 280G(a), 280G(b)(2)(ii), 4999; Regs., Q/A-1, Q/A-3.

⁸ “Private” here means that the corporation’s shares are not readily tradable on an established securities market or otherwise. See Code § 280G(b)(5).

Both of these methods are clumsy and counterintuitive because neither Congress nor the Internal Revenue Service intends that the regime facilitate parachute payments. On the contrary, the requirements are deliberately awkward and force accommodations that are contrary to normal business practice.⁹

In designing a compensation package that includes parachute payments, employers are frequently tempted to avoid complexity and just pay the tax, usually offering to reimburse the employee for at least some of the excise (and perhaps all or part of the regular income tax) that is imposed on the parachute payments. This route, however, can itself be complicated as well as surprisingly expensive. Such tax reimbursements by the employer are themselves parachute payments, and so are themselves subject to the excise, as well as to regular income and payroll taxes. If the corporation is generous and “grosses up” the parachute payment so that the employee receives the full stated amount (net of all taxes), the cost to the company will approach \$3.50 for every dollar received by the employee.¹⁰

4. Uncertainties Impede Planning

For the practitioner who is structuring executive compensation, perhaps the most discouraging aspect of the regulations is that they preclude careful planning when an employment agreement is being first negotiated, at the time of hiring. One is forced to set a few bricks – and let the mortar harden – before designing the edifice.

At hiring, the employee’s exact future compensation will typically be speculative, since it will vary with the employee’s individual performance as well as with the company’s overall success. As a result, the “base amount” will be known only within a fairly broad range. The safe harbor threshold, which is by definition three times the base amount, will similarly be speculative and will vary across an even wider range. Parachute payments must therefore generally be negotiated and fixed by the employment agreement with little basis for knowing whether they will exceed the safe harbor. Moreover, in the case of private companies, the approval of company shareholders cannot be obtained at the time of hiring because it is too early to do so; the regulations require that approval be obtained within six months of the change in control.¹¹

Serious parachute tax issues are therefore likely to actually arise in the context of a pending change in control, at which time key employees may be entitled, under *pre-*

⁹ See General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, Joint Committee on Taxation (1984), at pp. 199-207; see also T.D. 9083, IRS Final Rules on I.R.C. § 280G Golden Parachute Payments (August 1, 2003). Separately from the golden parachute regulations, recently proposed rules of the Securities and Exchange Commission would require of public companies a detailed disclosure of parachute payment arrangements, as well as of other aspects of executive compensation; see SEC Release #33-8735A, “Executive Compensation and Related Person Disclosure (conforming amendments),” August 29, 2006.

¹⁰ Assuming the highest federal rates, and including the effects of federal payroll taxes, state and local income taxes (estimated at 5%) and the non-deductibility of the parachute expense.

¹¹ Regs., Q/A-7(a)(2).

existing agreements, to parachute payments that must then be quantified, and determined to be either less or more than the safe harbor threshold. Even at this date, the exact amount of both the payments and the safe harbor are likely to be known only approximately. If the possibility exists for any particular employee that the total amount of parachute payments will exceed the safe harbor threshold, the employee and the company may face difficult choices. In the case of private corporations, the draconian tax consequences can be avoided if shareholder approval can be obtained for the payments, but the employee has to waive the payments if not approved, effectively making these amounts contingent on uncertain shareholder approval.¹²

Only the payments that exceed the safe harbor threshold must be submitted for approval,¹³ but the uncertainty of the figures will prompt all concerned to desire some margin for error. The corporation (and its potential buyers) may desire the greatest possible margin by requesting shareholder approval of any and all payments that might *conceivably* be characterized as parachutes, which necessarily requires that the employee put all pre-existing rights to such payments at risk. On the other hand, the employees will not want to waive, and should not be advised to waive, amounts that are likely not to be parachutes, or that are likely to be well below the safe harbor threshold.

To negotiate the waiver and to design the approval process intelligently, both the company and the employee (and their advisors) must carefully analyze the potential payments and their characteristics. The analysis is hampered by the intrinsic qualitative and quantitative uncertainties interposed by the regulations, as the examples below illustrate.

a. *Qualitative Uncertainty: Is the Payment a Parachute?*

For many elements of a typical executive compensation package, it is difficult to determine whether each payment or benefit is classified as a “parachute payment” subject to the regulations. Generally a payment or benefit is so classified if it is both (i) contingent on a change in control and (ii) compensatory in nature.¹⁴ Whether one or both of these conditions are fulfilled as to any particular payment is often obscure.

Certainly, a payment may be “contingent on a change in control” under the regulations even if it was not designed to be so. Under the “one year rule,” a payment is presumed to be contingent on a change in control if the payment is contingent on an event that is closely associated with a change in control, the change in control actually occurs, and the payment is made within one year of the change in control.¹⁵ Executive compensation agreements typically provide for disbursements that are payable upon termination of employment without good cause; such payments are treated as golden

¹² Code § 280G(b)(5); Regs., Q/A-6(a)(2)(ii), Q/A-7.

¹³ The regulations clearly allow approval to be sought for only a portion of the parachute payments. Regs., Q/A-7(a)(1).

¹⁴ Regs., Q/A-2(a).

¹⁵ Regs., Q/A-22(b)(3).

parachute payments if in fact the termination is made without good cause and is “materially connected” with a change in control. Whether a termination is so “materially connected” is a question of fact, but the connection is presumed if termination is within one year of the change.

The same “one year rule” also applies to the period *following* the change in control transaction, and similar uncertainty can exist. If an employee is terminated within one year after a change in control, the regulations demand an assumption that any severance payments triggered by the termination were contingent upon the change in control. When such a termination occurs just after the one-year mark, uncertainty will exist whether the payment is a parachute.

There is, similarly, considerable uncertainty as to whether a so-called “retention payment” is contingent on a change in control. Certainly, if a company anticipates a change in control and issues a bonus to employees as an incentive to stay through the transitional period, this payment is a parachute, but facts are rarely so clear. More often, a private company’s management may conjecture that the company can be profitably sold and, in the face of such hopeful speculation, may offer additional compensation to key people, contingent upon their staying on for a minimum term. It is likely to be unclear whether such a payment made thirteen months prior to a change in control is “materially connected” to the change, and so it will also be unclear whether the retention payment is a parachute that “counts” towards the safe harbor threshold. The employee, having already cashed the check, may be especially unwilling to waive this retention payment retroactively on the dubious assertion that it might be a parachute and so require shareholder approval.

Even where it is clear that a given payment is contingent on a change in control, it may not be clear whether the payment is “compensatory.” This issue is typically presented when vested stock is held by an employee, and a potential buyer has made an offer to purchase all of the outstanding stock, which has caused the value of the stock held by the employee to increase. Whether this increase in the value of the employee’s stock is itself a parachute payment is fuzzy. To complicate matters, the buyer may offer a premium price to employee-stockholders, which can readily be done if these shares are identified as a separate class of stock. It is likely that both the price increase and the premium paid for employee-held shares are directly attributable to the change in control, and therefore will be parachute payments if they are also compensatory.¹⁶ Although such increases in stock value are typically thought to be noncompensatory capital gain, both the increase and the premium can be deemed to be compensatory payments depending on the terms under which the stock was originally received by the employee.

¹⁶ See Regs., Q/A-12. In determining parachute status, it makes no difference that the payment for the stock price will come from the buyer rather than the employer corporation. Regs., Q/A-10(ii). It may make a difference in determining whether the parachute is “wages” subject to payroll taxes.

Whether the price increase is a compensatory payment will be controlled by Section 83 of the Code.¹⁷ Under that section, as a general principle, if the employee was taxable on receipt of the stock at the time of vesting, the subsequent gain on the stock, including the increase due to the recent offer, will be non-compensatory capital gain. However, to the extent that the employee was not taxable at the time of vesting, the gain will be compensatory (and will be ordinary income). Also in general, if the stock is subject to a “nonlapse restriction,” then at the time of vesting the employee is taxed only on the fair market value of the stock as reduced by the nonlapse restriction. As a result, the subsequent removal of the nonlapse restriction upon a change in control will be compensatory (and ordinary income) at the time the restriction is removed.¹⁸

For many stock rights and stock options issued to employees, it may not be clear whether a restriction is lapse or nonlapse, and therefore it may be indistinct whether the subsequent gain in value is compensation, or non-compensatory capital gain. The following example illustrates the difficulty of determining the presence of a “nonlapse restriction” in the context of an expected change in control:

Example 1. Pursuant to employment agreements, employees are granted stock options for Class B stock, which is a class issued only to employees and subject to transfer restrictions. Class B stock is preferred as to dividends and liquidation distributions, and is convertible to Class A common stock upon a change in control of the company at the option of the stockholder. Class B shares can be sold only to the company, but the company is obligated to buy the stock if offered, at a price determined by a formula, which formula represents a good faith attempt to determine actual fair market value of the stock. At the time of a proposed change in control, all of the Class B stock has vested, the formulaic price for these shares is \$x per share, and neither Class A nor Class B stock trades publicly. Seeking to acquire the company, a third party offers \$x per share for Class A stock and a higher figure, \$y per share, for Class B stock. Assuming the offer ripens into a change in control of the company, is the price premium (\$y- x per share) compensation?

Analysis. The transfer restriction on the Class B shares is effectively removed by the change in control. The increment in value due to this removal will be compensatory if it represents the termination of a non-lapse restriction.¹⁹ Generally, a requirement that stock must be sold only to the company at a formulaic price is a non-lapse restriction.²⁰ In contrast, a requirement to sell

¹⁷ Regs., Q/A-12(a). Note that an election under Code § 83(b) does not affect whether the payment is treated as a parachute.

¹⁸ Treas. Reg., § 1.83-5(b). Note that a “lapse” restriction does not reduce the taxable value of the stock at the time of vesting; rather the employee is taxed on the full fair market value of the stock, as calculated *without considering* the lapse restriction. Therefore the removal of “lapse” restriction generally does not result in compensatory income (rather, in noncompensatory capital gain).

¹⁹ Treas. Reg., § 1.83-5(b).

²⁰ Treas. Reg. § 1.83-5(c), Example 2.

shares only to the company is a lapse restriction if the company is required to pay actual fair market value.²¹ In this particular example, that the formula is designed to mimic fair market value brings the restriction to an uncertain middle ground; it may be “lapse” or “nonlapse” depending on how accurately the formula works to predict fair market value. As a result, it is unclear whether the increment in value of the stock due to the change in control is compensatory or not. If it is, it is also a parachute payment.

b. Quantitative Uncertainty: How much is the Payment?

In general, parachute payments include broadly the value of all cash payments, benefits, and vesting of property that are connected to a change in control. The value of continued medical and fringe benefits, as well as of outplacement and similar services, must be factored into the calculation. Amounts to be paid in the future are generally discounted to net present value. Payments made into a qualified plan (*e.g.*, a Section 401(k) plan) do not count as parachutes,²² but cash payments made in lieu of plan contributions do count.

To determine whether the “safe harbor” threshold is exceeded, both the exact “base amount” and the exact total of the “parachute payments” must be determined. A working knowledge of Lotus 123, Excel or QuattroPro spreadsheets is handy when making these calculations. However, that mathematics can be applied to the problem should not mislead the practitioner to believe that the amounts can be determined with mathematical certainty. In addition to the very real possibility of computational error, all of the calculations must be based on factual assumptions which will necessarily be uncertain.

The acceleration of vesting due to a change in control, *i.e.*, the vesting of property at a time earlier than would have otherwise occurred but for the change in control, is itself a parachute payment.²³ In this case, the parachute includes only the amount by which the accelerated payment exceeds the present value of the payment absent the acceleration.²⁴ A discount rate of 120% of the applicable federal rate is used in calculating the value of the acceleration.²⁵

Example 2: An employee holds ten shares of unvested restricted stock which will vest in one year, or upon a change in control if earlier. The employee is restricted from selling the stock except upon a change of control of the company, but the employee at any time can require the company to purchase his vested stock for a per-share price determined under a formula, which price would be \$40 per share today and (it is estimated) will be \$40 per share one year from now. The stock

²¹ PLR 8506001.

²² Code § 280G(b)(6).

²³ See Regs., Q/A-12.

²⁴ Regs., Q/A-24(a)(1), Q/A-24(b).

²⁵ Regs., Q/A-32. The APR is determined periodically by the IRS pursuant to Code § 1274(d).

recently traded at \$33 per share, but a third-party offer to acquire all of the outstanding company stock has raised the market value to \$45 per share. The current applicable federal rate is 5.00%. If the offer effects a change in control, what is the amount of the parachute payment?

Analysis: But for the change in control, the employee would realize \$400 in compensation income one year from now, and the present value of the future \$400 payment (using a discount factor of 6.00%, *i.e.*, 120% of 5.00%) is \$377. The payment is accelerated by the change in control, and the value of the acceleration is $\$400 - 377 = \23 . The employee also realizes an additional \$50 premium from the increase in fair market value of the shares, which is also a parachute. The total amount of the parachute payment is therefore \$73.

In the preceding example, one might reasonably mistake the amount of the parachute to be either the total amount of the accelerated vesting (\$450), or the increase in value due to the offer (\$120); both are incorrect, illustrating the ease with which computational errors can be made. Further uncertainty is introduced in the example by the estimated future value of vested stock, which is assumed to be equal to its formulaic value today, an assumption that may or may not prove accurate.

In short, the uncertainty of classification, the chance of miscalculation and the necessary use of factual assumptions will make the two key figures – the total amount of potential parachute payments and the base amount – determinable only within a range.

5. Practical Solutions

a. Limiting the Parachute at Hiring

Notwithstanding this uncertainty, two strategies exist at the time of hiring, in the form of provisions included in the employment agreement, that will maximize the parachute payments while avoiding the excise. These provisions are known colloquially as the “299 waiver” and the “take less to get more” provision.

Under the “299 waiver,” the employee waives any compensation that is contingent on a change in control, to the extent that such compensation exceeds 299% of the employee’s “base amount” as determined under Code Section 280G. Note that the 299% figure is used, rather than a 300% figure, because the safe harbor does not apply if the total of parachute payments “*equals or exceeds* an amount equal to three times the base amount.”²⁶ This provision, in a conceptually straightforward manner, ensures that parachute compensation will never exceed the safe harbor threshold; it also ensures that the employee may receive parachute payments at the maximum value that is possible without invoking the excise.

As a practical matter, the mechanics of implementing the 299 waiver can be problematic, again because parachute payments typically will include a variety of

²⁶ Code § 280G(b)(2)(ii); *see also* Regs., Q/A-30(a).

different rights and benefits, some of which will be of uncertain value. It may avoid confusion and later disputes to provide in the employment agreement a mechanism for determining what cash, rights, or benefits are actually waived by the employee, and in what order, should the safe harbor threshold be exceeded. Alternatively, the employee can be provided an option to select at the time of payment which benefits will be waived in what amounts, although in this case, some order of election should be designated as a default, should the employee not make the election within a specified time period. In any event, a process for dispute resolution should be specified in case the fair market value of certain elements cannot be determined, or cannot be agreed upon. Bear in mind that not only must the parties agree on the value of each payment, but the value should be determined conservatively in order to reduce the likelihood of a later assessment on audit.

The “take less to get more” provision pursues a similar strategy, but requires the employer to determine, at the time of the payment, whether it is more beneficial to the employee to be paid the full amount of the parachute payment (and to pay any resulting excise), or instead to be paid 299% of the base amount and avoid any excise payment. The employer must then, between these two options, make the payment that will provide the greater benefit to the employee, net of the excise.²⁷ The employee generally will enjoy a greater net benefit by taking 299% of the base amount if the total of parachute payments is more than *three* times but less than about *four* times the base amount; within this range, a relatively large excise can be avoided by foregoing the relatively small portion of the payment that exceeds the three-times-base-amount threshold. However, if the total parachute payment exceeds about *four* times the base amount, the employee is generally better off receiving the full amount into income, and paying both the excise and regular income tax on that amount.²⁸ The provision is clearly employee-favorable, since the consequences to the corporation (including the non-deductibility of the payment and any requirement to gross up taxes, as well as the cost of the payment itself) are generally not factored into the choice.

b. *Increasing the Base Amount in View of the Change in Control*

An employee’s base amount can sometimes be adjusted at the time when a change in control is contemplated, such that the safe harbor threshold is increased above the total of the parachute payments. Increasing the base amount works as a method to avoid or reduce the excise only if a change in control is anticipated in a later (not the current) tax year.²⁹ It is usually effected by accelerating the vesting of otherwise deferred compensation (such as unvested stock options or other rights) so that the income is

²⁷ An alternative, allowing the employee to elect between the two amounts, might cause the employee constructively to receive the larger amount. *See* Rev. Rul. 60-31, 1960-1 C.B. 174 and Code Section 451.

²⁸ For example, if the employee’s base amount is \$1.0m, she will prefer to accept a parachute equal to \$4.0m rather than making the waiver. On this \$4.0m, she will pay the excise (20% of \$3.0m = \$0.6m) and the income tax (35% of \$4.0m = \$1.4m), leaving her a net benefit of \$2.0m. Alternatively, if she waives the excess over \$2.99m, she will avoid the excise and pay only the income tax (.35% of \$2.99m = \$1.05m), but this will leave her a net benefit of only \$1.95m. The example assumes federal income tax at the current highest 35% marginal rate.

²⁹ Regs., Q/A-35.

included as compensation in the current year, rather than in the year of the change in control. By thus shifting the timing of these compensatory payments to within the five-year period *prior to* the year of the change in control, the employee's base amount is effectively increased. Generally, each dollar of taxable compensation that is shifted into the base period will increase the safe harbor threshold by sixty cents.³⁰

c. Waiver Prerequisite to Shareholder Approval

When an employee of a *private* corporation is entitled to a large parachute payment under a pre-existing agreement, the employee can keep the full amount of the parachute (and the company can deduct the full amount as compensation paid) if the company obtains shareholder approval.³¹ The regulations, however, hinder this approval in three ways. First, the approval is valid only if the employee will *not* receive the payment if it is *not* approved,³² which means that the employee must waive any pre-existing rights to the payment in the event of disapproval. Second, the change in control transaction may not itself be contingent upon the parachute approval.³³ Third, the approval vote must meet fairly exacting procedural requirements, including "adequate disclosure" to "every shareholder" entitled to vote.³⁴

The waiver should be drafted such that the employee's pre-existing rights in the payment are waived upon the shareholders' failure to approve the payment, or more specifically, such that the waiver is effective at the time of the change in control if approval has not by that time been secured. The alternative, which is to draft such that the employee first waives an already-vested payment, and then is entitled to reinstatement of the payment upon approval, would raise phantom income problems and potential double taxation, and might cause forfeiture of the payment if the change in control transaction itself falls through.

³⁰ Since the base amount usually represents a five-year average, a one dollar increase in the final year will increase the base amount by twenty cents; this will increase the safe harbor threshold, which is three times the base amount, by sixty cents. If the employee has not worked the full five year period, the average is taken over a period shorter than five years, and the impact of the shift can be greater. Note that short year periods are annualized *before* averaging across years, with the result that the base amount differs slightly from the arithmetic mean of the employee's compensation. See Regs., Q/A-35, Example 1. A careful review of the methods prescribed in the regulations for calculating the base amount, Regs., Q/A-34, Q/A-35, Q/A-36, is advised.

³¹ Code § 280G(b)(5).

³² Regs., Q/A-7(b)(1), provides in part: "the vote...must determine the right of the [employee] to receive the payment, or, in the case of a payment made before the vote, the right of the [employee] to retain the payment."

³³ Regs., Q/A-7(b)(1), provides in part: "The requirements of [this regulation] are not satisfied if approval of the change in ownership or control is contingent, or otherwise conditioned, on the approval of any payment...that would be a parachute payment but for [shareholder approval]...". Note that the reverse *is* permitted: the parachute approval may be conditioned on the approval of the change in control transaction. As a result, the parachute waiver may (and should) contain a *proviso* that it is null and void should the change in control transaction not close.

³⁴ Code § 280G(b)(5)(B); Regs., Q/A-7.

It is, of course, not permitted that an employee be indemnified as to any waived payment, by a side agreement or otherwise. Although nothing prevents a shareholder from “looking the employee in the eye” and stating an intention to vote affirmatively, any binding assurance that the employee will receive the payment absent shareholder approval will invalidate the approval. The employee must be advised that the possibility exists – indeed, the possibility *must* exist – that notwithstanding any oral assurances the shareholders might vote against approval, in which case the payment will be forfeited by the employee. In that event, any legal claim against the shareholders, for fraud in the inducement or otherwise, is not likely to be seriously entertained.

The requirement that the employee waive non-approved payments puts the interests of the employer and employee in direct conflict. While both parties want to avoid parachute classification of the payments, the employee wants to waive as little as possible, while the corporation will prefer to maximize its assurance by requiring the waiver of *all* potential parachute payments. There are two ways to resolve this conflict; although neither has ever been formally sanctioned by the Internal Revenue Service or tested in court, both methods are drawn on frequently by practitioners.

The first and perhaps more traditional method is to waive certain categories of payments while retaining others. This method depends on having accurate assessments of the fair market value of each parachute payment, which (as noted above) can be difficult to obtain. Assuming the parties can agree on the value of each payment, they must also agree that the employee will not waive but keep only certain payments, whose total value is well below the safe harbor, in order to provide margin for error against the uncertainty of valuation. This means that the employee will waive somewhat more than he has to. Despite this shortcoming, however, this method is routinely employed and has the (perhaps dubious) advantage that many tax professionals seem comfortable with it.

The second and more modern method is to mimic the 299 waiver suggested above, but at the time that a change in control is anticipated, rather than at the time of hiring. That is, the employee can generically waive all parachutes exceeding 299% of the base amount, with some algorithm provided for determining exactly which payments will be retained. This has the significant advantage that the employee waives only the minimum necessary to effect the approval. The only serious drawback to this method is that since it leaves undetermined exactly which payments the shareholders are approving, arguably there is some doubt whether the approval is effective. Careful drafting of the shareholder disclosure, however, should help address any such concern: The disclosure should state that if approval is not granted, the employee will receive parachute benefits under pre-existing agreements but only to the extent of 299% of his base amount (average salary); if approval is granted, he will receive the entire amount due to him under pre-existing contracts. While this method is perhaps less popular than the category-based waiver, it nevertheless enjoys wide use by practitioners.

d. Structuring the Approval Vote

The employee and the employer will share the common goal that the shareholder approval process should meet the stringent requirements of the golden parachute

regulations. The employee, however, will have the additional goal that the approval vote should actually be successful. The employer, on the other hand, is likely to be (at best) indifferent, and may (at worst) see the approval process as a windfall opportunity to escape – without legal consequences – a burdensome pre-existing obligation.

The employee will be well advised to try to structure the approval process so as to maximize the probability of approval, and in this the employee's key leverage lies in timing. If the payment approval vote precedes the vote concerning the change in control transaction itself, the executive may be able, as a practical matter, to thwart the transaction if the payment is not approved. Similarly, the employee may be able to derail any minority consent, or waiver of minority shareholders' rights, regarding the change in control transaction. These forms of leverage appear to be permitted under the regulations, as long as the transaction vote is not itself contingent upon approval of the payment.³⁵

Care should be taken to comply with the requirement that the change in ownership cannot be contingent upon approval of the parachute payments.³⁶ It is common practice for the buyers in a transaction to require, as a condition of closing and as a surviving representation, that the company not make or become obligated to make any parachute payment that will be non-deductible. Buyers sometimes go a step further and demand that the company obtain shareholder approval as to any parachute payments that have been or will be made. It is not clear whether such a provision invalidates the approval under the regulations. The requirement is arguably permitted so long it binds only the company and does not bind the shareholders themselves, and so long as approval of the change in control transaction is by a vote that is separate and independent from the payment approval. Nevertheless, the risk of violating the regulations can be reduced by drafting any such provision in the alternative, such that the selling shareholders are obligated *either* to obtain shareholder consent *or* to bear the tax costs related to the parachute payment. In this way it is clear that the shareholders can sell the company and yet vote against the payments.

The requirement for "adequate disclosure" is fulfilled only if full disclosure of all material facts is made to *every* shareholder entitled to vote.³⁷ Hence, for example, even if more than 75% of the voting shareholders are present at a properly called meeting, and even if (after full disclosure to them) they all vote to approve the payment, the approval still fails if disclosure has not been made to the minority stockholders who are not present.³⁸

³⁵ Regs., Q/A-7(b)(1).

³⁶ Regs., Q/A-7(b)(1).

³⁷ Generally, this includes every holder of voting stock except the employee or other "disqualified individual" whose payment is at issue, and certain related persons. Regs., Q/A-7(c). Shares held by the "disqualified individual" and related persons may not be voted and are not counted in determining the 75% majority required. Regs., Q/A-7(b)(4).

³⁸ Regs., Q/A-7(e), Example 6.

The *form* of the disclosure required is relatively clear, and the company is well advised to make a very complete disclosure, since every fact that a reasonable shareholder would likely consider important must be included.³⁹ At a minimum, the disclosure must include (a) the event triggering the payments, (b) the total amount of the payments that would be parachute payments if approved, and (c) a brief description of each payment.⁴⁰ A typical and helpful format is a detailed spreadsheet with one column showing the payments that will be made to the executive absent the approval, and another column showing the payments that will be made if the payments are approved.

The *timing* of the required disclosure is much less clear, since the regulations do not specify when the disclosure must be made, except that it must be “before the vote.”⁴¹ The more conservative, and perhaps better reasoned, view is that the disclosure must be made sufficiently in advance of the vote that a minority shareholder who objects to the payment will have a meaningful opportunity to make his opinions known to the other shareholders. A more aggressive view is that a written disclosure mailed to all shareholders prior to the vote (even if received by some shareholders after the vote) is acceptable so long as a 75% majority received the disclosure prior to the vote and then voted affirmatively. This latter view has the advantage of avoiding delay, which is significant because change in control transactions are generally characterized by urgency. However, while the regulations are not literally inconsistent with this interpretation, it would seem to render meaningless the “every shareholder” requirement; there is no reason for the regulations to insist so clearly on disclosure to *every* shareholder if some shareholders have no opportunity to influence the actual vote.

Once the full disclosure has been made, a consent resolution, conference call, or other process can be used for the actual vote, so long as it is authorized by the corporation’s own by-laws and by the laws of the relevant state.⁴² Hence, a successful vote can take the following form: Full, written disclosure is mailed to all shareholders ten days before the date specified for the vote; on that specified day, a consent resolution is circulated among a handful of shareholders, who together hold more than 75% of the voting shares, and all of them sign the consent. The vote is valid even though the minority shareholders have no opportunity to vote, because they had notice in sufficient time to share their opinions with the majority that did vote.

e. *Protecting the Buyer*

A key concern of the buyer will be avoiding a later determination on audit that a significant payment was nondeductible as a parachute. Such a determination, if it occurs, will most likely have been due to either (a) the company’s misclassification of a parachute payment as outside the regulations, or (b) the procedural failure of a

³⁹ Regs., Q/A-7(c).

⁴⁰ Regs., Q/A-7(c).

⁴¹ Regs., Q/A-7(a)(2).

⁴² Regs., Q/A-7(b)(1), provides: “...except as otherwise required...the normal voting rules of the corporation are applicable.”

shareholder approval vote.⁴³ The buyer therefore has an interest, aligned with the company's interest, in properly identifying parachute payments and the amount of each, and (where applicable) ensuring that the shareholder approval procedures are followed rigorously. The buyer may therefore reasonably ask to review the company's valuations, procedures and documents associated with potential parachute payments. In addition, the buyer might demand from the selling shareholders indemnification against future assessments. This may be feasible where the selling group consists of only a handful of shareholders, and may be *de rigueur* where the company has taken aggressive positions as to the classification or valuation of payments.

6. Conclusion

Parachute payments represent a serious tax concern. Notwithstanding that such payments are often necessary to attract top executive talent and to ensure their support for the investors' exit strategy, the current regulations are intended to discourage such payments. A typical executive compensation package can quite inadvertently include parachute payments that exceed the safe harbor threshold; the resulting tax expense can be acute, to the point of prohibiting a change-in-control deal. The regulations, by making it difficult to plan parachute payments in advance, impede "preventive care" and instead force "tax triage" at the time when a change in control is imminent. Nevertheless, careful attention, and the use of the techniques described above, by and large can ensure that substantial payments to key executives are protected, and that the excise is avoided.

⁴³ Post-closing parachute payments are also a concern. In particular, severance payments made in connection with the subsequent dismissal of employees who were retained through the transition period could be classified as parachutes.