An Overview of the Golden Parachute Payment Rules

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Often, executives of private companies have certain rights and benefits that are triggered upon a change in control, such as accelerated vesting of equity awards and payments under a management carve-out plan. These payments may result in significant tax penalties under Section 280G of the Internal Revenue Code, or the "Golden Parachute Rules", unless appropriate action is taken by the company. Section 280G was enacted by Congress in an attempt to discourage the payment of significant compensation to executives of companies as "golden parachutes" in connection with an exit event, at the expense of other stockholders.

Who is covered:

In general, 280G applies to officers, highly compensated individuals and 1% shareholders of a C-Corporation that undergoes a change in control. 280G does not typically apply to companies that are organized as an LLC or an S-Corporation, and also does not apply to any C-Corporation that is eligible to be treated as an S-Corporation.

Threshold:

280G is triggered when any covered individual receives payments in the nature of compensation in connection with a change of control in excess of 3 times his or her "base amount", which is defined as his or her average annual compensation over the previous five years (pro-rated for any partial periods). However, once this 3x threshold has been exceeded, the penalties under 280G apply to the "excess parachute payments", meaning all change in control payments in excess of one times the base amount.

Consequences:

Excess parachute payments are subject to an additional 20% excise tax to the recipient (in addition to the ordinary tax rates that otherwise apply). Also, the amounts paid to the individual are non-deductible by the paying corporation.

Payments by Target within the scope of 280G:

Payments to an individual from a target entity prior to or at the time of closing may include transaction bonuses (including payments under a management carve-out plan), severance benefits and the value of any accelerated vesting of options and restricted stock grants. 280G also presumes that any payment made to a covered executive pursuant to an agreement entered into within one year prior to a change of control is made in connection with the change in control. Payments are excluded, however, to the extent that they can be shown to be reasonable compensation for services provided.

Payments after Closing within the scope of 280G:

Payments made after the closing of the transaction, such as a retention bonus or any severance upon separation of service, are generally also subject to 280G. Again, amounts paid by the buyer or surviving company post-closing can be excluded from the 280G analysis to the extent such payments are reasonable compensation for services provided post-closing.

Stockholder Vote:

For executives whose aggregate change in control compensation is over the threshold, all is not lost. Generally, private companies may avoid the application of 280G by obtaining a shareholder vote approving the parachute payments. The vote must be approved by 75% in interest of all shareholders who are entitled to vote (excluding from the vote any persons who are receiving parachute payments in connection with such transaction). However, to receive this protection, an executive must first agree that if the shareholder vote fails, he or she will waive any right to any change in control compensation in excess of the 3x threshold. Additionally, if the corporation seeks a cleansing shareholder vote, 280G requires a disclosure of all material facts regarding the change in control payments to all stockholders who are entitled to vote.

This article is intended to provide a brief introduction to the Golden Parachute Payment rules. As the rules under 280G can be somewhat complex and technical, it is advisable to analyze any potential impact of 280G early in any potential M&A transaction.

For more information, please contact **Dave Czarnecki**.