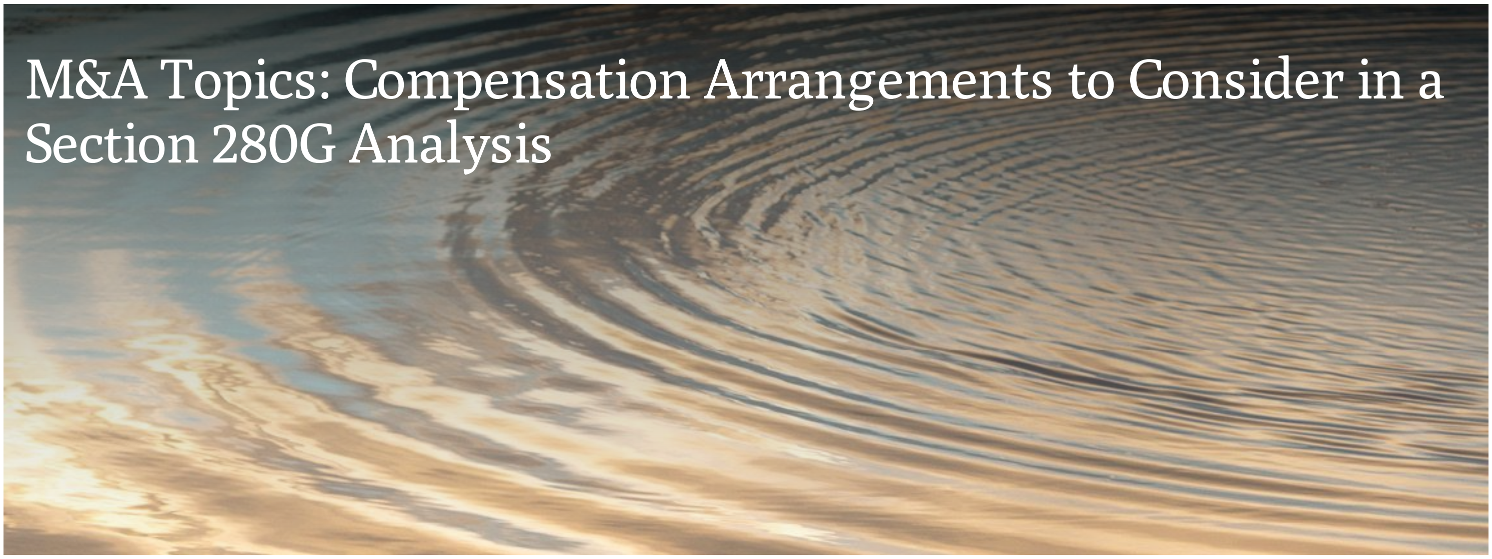
BLOG

M&A Topics: Compensation Arrangements to Consider in a Section 280G Analysis



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Section 280G of the Internal Revenue Code is intended to discourage excessive compensation (sometimes referred to as “golden parachute payments”) to certain officers, highly compensated individuals, and greater than 1% shareholders (called “disqualified individuals”) of a corporation undergoing a change in control. Parachute payments include any compensatory payments or benefits contingent upon a change in control.

If parachute payments exceed three times (3x) the disqualified individual’s base amount (the average taxable compensation from the company over the five most recent tax years before the change in control), adverse tax penalties are imposed on both the company (in the form of tax deduction losses) and the individual (in the form of a 20% excise tax) for payments in excess of the disqualified individual’s base amount. In other words, parachute payments may go up to three times (3x) the disqualified individual’s base amount, but if those payments equal or exceed three times (3x) the disqualified individual’s base amount, adverse tax penalties apply to a wider range in excess of one times (1x) the disqualified individual’s base amount.

This is why it is very important that companies consider all forms of golden parachute payments when conducting a Section 280G analysis in order to determine the full extent of these tax consequences. Below are examples of what may constitute parachute payments:

- Any transaction bonuses, including any payments made in connection to the change in control.
- Any severance or benefits continuation.
- Any retention, stay, or performance-based bonus payment amounts.
- Any changes made to employment agreements within 12 months before the change in control.
- Any equity grants, including stock options, restricted stock, phantom stock, or stock appreciation awards (especially, any equity grants awarded within 12 months before the change in control).
- Any accelerated vesting and/or distribution of nonqualified deferred compensation amounts.
- Any post-change in control buyer arrangements, either promised or in place, that provide for an increase in salary, bonuses, and/or buyer equity.

- Any gross-up payment amounts (in some instances, companies will “gross up” payments to individuals to cover their excise tax; this gross-up is also considered a parachute payment).

Winston & Strawn’s Employee Benefits & Executive Compensation Practice is available to help companies assess the potential Section 280G implications of their transactions and provide more information regarding the Section 280G analysis process.
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