ExeComp SOLUTIONS LLC
Executive Compensation Consulting & Advisory Services

INTERNAL REVENUE CODE SECTION 280G PRIMER

The "golden parachute" rules under Internal Revenue Code (the "Code") Section 280G provide that if a "Disqualified Individual" ("DI") receives compensatory payments and benefits (e.g., severance, continued health and welfare benefits after termination of employment, enhanced retirement benefits, accelerated vesting of equity compensation) which (1) are contingent on a change in control ("CIC") and (2) have an aggregate present value which equals or exceeds ***three*** times the DI's "Base Amount" then such payments are treated as "parachute payments". As such, to the extent the present value of the contingent payments do not exceed what is often referred to as the "golden parachute threshold amount" or "280G threshold amount" ($1 less than three times the DI's Base Amount), then the payments are not considered to be parachute payments. Generally, if a payment is contingent on the CIC then the full amount of such payment is treated as a continent payment under. However, there are numerous exceptions and complexities when dealing with certain types of payments such as accelerated vesting of equity compensation (e.g., stock options, restricted stock, and performance shares).

Generally, an "excess parachute payment" is the amount equal to the excess of any *parachute payment* over the Base Amount allocated to such parachute payment (once the 280G threshold amount is exceeded then amounts in excess of *one* times the Base Amount are treated as excess parachute payments). Excess parachute payments may be reduced by reasonable compensation for personal services rendered before the CIC though the reasonable compensation amount must first be reduced by the portion of the DI's Base Amount that is allocated to such amount. Excess parachute payments are not deductible by the company under Code Section 280G and the DI is subject to a 20% excise tax under Code Section 4999 on such amount. The disallowance of the deduction is not contingent on the imposition of the excise tax and vice versa.

Base Amount

Base Amount is the DI's average taxable compensation for the five years prior to the CIC. Generally, this is the amount reported in Box 1 of Form W-2, Box 3 and/or Box 7 of Form 1099, and equivalent amounts for compensation paid to foreign employees. If the DI did not provide services for the entire five-year period, compensation is averaged over the DI's service period. Recurring compensation can be annualized for short-year periods. One-time payments (e.g., sign-on bonuses, relocation payments) cannot be annualized.

Disqualified Individuals

Disqualified individuals include the following individuals in the following three categories:

1. Shareholders – individuals who own stock of the corporation with a fair market value that exceeds 1% of the fair market value of the outstanding stock of all classes of the corporation's stock;
2. Officers - limited to 50 employees or, if less, the greater of 3 employees, or 10 percent of the employees (rounded up to the nearest integer) of the corporation; and
3. Highly compensated individuals - limited to the lesser of the highest paid 250 employees or 1 percent of the employees of the corporation

Exemptions

Exemptions from the definition of the term parachute payment include:

- Payments by a corporation which would qualify as a small business corporation (e.g. "S-Corporation") as defined by IRC Code Section 1361(b);
- Certain payments by non-public corporations other than small business corporations, if immediately before the CIC, no stock in such corporation was readily tradable on an established securities market or otherwise and to the extent certain shareholder approval requirements are satisfied;
- Payments to or from a qualified plan;
- Payments from certain "tax-exempt organizations"; and
- Certain payments of reasonable compensation to be rendered on or after the CIC.

Additionally, payments made pursuant to an agreement entered into after the CIC are not treated as contingent on the CIC. However, to the extent a post-CIC agreement is entered into pursuant to a legally binding agreement which was entered into prior to the CIC, the agreement will be considered a pre-CIC agreement. If a post-CIC payment is a replacement of a vested pre-CIC payment, then the post-CIC payment is treated as a post-CIC payment (i.e., exempt from treatment as a contingent payment) only to the extent the value of the payment exceeds the value of the pre-CIC payment.

Who Can Make a Parachute Payment?

Parachute payments may be paid, directly or indirectly, by the "corporation" undergoing the CIC, the person acquiring control of such corporation, or any person related to such corporation whereby attribution of stock ownership is required under IRC Section 318(a). All members of the same affiliated group (as defined in Code Section 1504, determined without regard to Code Section 1504(b)) are treated as one corporation. Based on these rules, a normal partnership (other than a publicly traded partnership treated as a corporation under IRC Section 7704(a)) could not be a payor of parachute payments and would not be subject to the golden parachute rules.

Accelerated Payment and Vesting

Question and Answer ("Q/A") 24(b) and 24(c) of the regulations contain exceptions to the general rule providing for inclusion of the entire amount of a payment as a contingent payment (once amounts are taken into consideration under these sections the amounts may not be reduced by reasonable compensation). Q/A-24(b) applies to payments which are vested without regard to the CIC, but which are accelerated as a result of the CIC. Under these circumstances, the amount that is treated as a contingent payment is the amount by which the amount of the accelerated payment exceeds the present value of the payment absent the acceleration (sometimes referred to as the "present value factor").

Q/A-24(b) is typically applicable less often than Q/A-24(c) which applies to a payment that becomes vested as a result of the CIC to the extent the payment would have vested based on the continued performance of services and the payment is attributable in part to the services rendered before the payment is made or certain to be made (i.e., accelerated vesting of time-vested stock options, restricted stock, and/or restricted stock units). The amount considered contingent on the CIC is computed by taking the sum of (1) 1% of the amount of the accelerated payment (usually the value of the restricted stock or the intrinsic value of an option in cash out situations) multiplied by the number of full months of accelerated vesting ("lapse factor") and (2) the present value factor determined under Q/A-24(b) (where an option is rolled over into options of the acquiring corporation, the new option received will need to be valued using an acceptable valuation method or the safe-harbor method set forth in Revenue Ruling 2003-68). This computation is commonly referred to as the "Q/A-24(c) computation" or simply "24(c) computation".

Performance Awards

To the extent it is not substantially certain that a payment would have been made absent the CIC, the entire payment is treated as a contingent on the CIC. If a payment vests based on the attainment of a performance goal and the goal is not met prior to the CIC, the full amount of the accelerated payment is treated as a contingent payment, although reductions for reasonable compensation prior to the-CIC can be made.