

ABC's of Section 280G

I. General background

- A. Enacted in 1984 to discourage corporations from making large payments to management upon change in control transactions, often at the expense of the shareholders.
- B. Tax consequences if Section 280G applies.
 - 1. 20% excise tax imposed on recipient of “*parachute payments*” in addition to regular taxes. Section 4999(a).
 - 2. Loss of deduction to payor corporation and obligation to withhold the excise tax. Section 280G(a); Section 4999(c)(1).
- C. The basic rule: if the present value of certain payments to certain individuals equals or exceeds three (3) times the individual's average taxable compensation for the five (5) years preceding the year of the change in control, the individual is subject to the 20% excise tax on the amount by which such payments exceed the individual's average compensation (“*excess parachute payments*”), and the corporation loses a deduction for the same amount.
- D. References to Q/A's in this outline are to Treas. Reg. Section 1.280G-1 promulgated on August 4, 2003 and applicable to parachute payments contingent upon a change in ownership or control occurring on or after January 1, 2004.

II. Strolling through the defined terms

- A. “Parachute payment” – A payment in the nature of compensation to a “*disqualified individual*” that is “*contingent*” on a “*change in ownership or control*” of the Target corporation if the aggregate of the present value of all such payments at the change in control date equals or exceeds three (3) times the disqualified individual's “*base amount*”.
 - 1. Examples of parachute payments.
 - a. Cash bonus.
 - b. Severance.
 - c. Continuation of benefits.
 - d. Accelerated vesting of equity grants.
 - e. Accelerated vesting of deferred compensation.
 - f. Retention payments.

2. The amount of a payment for purposes of measuring against 3 times base amount is generally the present value of the payment at the change in control date.
 3. The amount of a payment to the recipient for purposes of calculating the 20% excise tax is generally determined by reference to the amount actually paid to the recipient.
 - a. Generally, a payment is considered made in the taxable year in which it is includable in the disqualified individual's gross income or, in the case of benefits excludable from income, in the taxable year the benefits are received. Q/A-11(b).
 - b. A transfer of property is considered a payment made in the taxable year in which the property transferred is includable in the gross income of the disqualified individual under Section 83 (i.e., when transferred and substantially vested). Q/A-12(a).
 - c. However, a Section 83(b) election with respect to the transferred property does not apply for this purpose and the payment is generally considered made when the property is transferred and becomes substantially vested. Q/A-12(b).
 - d. For purposes of Section 280G, the vesting of an option is treated as a payment in the nature of compensation, and the value of the option is determined under the particular facts and circumstances. Q/A-13.
 - (i) Spread between fair market value of stock and exercise price if option is to be cashed out or terminated.
 - (ii) Black-Scholes valuation.
 - (iii) IRS valuation safe harbors (Rev. Proc. 2003-68).
 - e. Determination of the amount of certain vested and unvested payments that are treated as contingent on a change in control because the change *accelerates* the time at which the payments are made or vest is discussed in III. E, below.
- B. "Excess parachute payment" – the amount by which a parachute payment exceeds the base amount allocable to such parachute payment. Q/A-3.
1. The portion of the base amount allocated to a parachute payment is the amount that bears the same ratio to the base amount as the present value of such parachute payment bears to the aggregate present value of all parachute payments made to the same disqualified individual. Q/A-38.
 2. Excess parachute payments can be reduced by reasonable compensation for personal services actually rendered before the change in ownership or control. See discussion of reasonable compensation in III. B, below. Q/A-3, Q/A-39.

- C. “Disqualified individual” (this is not a moral concept) – an employee or independent contractor at any time during the “*disqualified individual determination period*” who is an officer, highly-compensated individual or greater-than-1% shareholder.
1. Officer. Q/A-18.
 - a. An individual who has the title of officer is presumed to be an officer.
 - b. An individual who does not have the title of officer may nevertheless be considered an officer if the facts and circumstances demonstrate that the individual has the authority of officer.
 - c. Generally, officer refers to an administrative executive who is in regular and continued service (typically not a person employed for a special and single transaction).
 - d. No more than 50 employees (or, if less, the greater of 3 employees or 10% of the employees of the corporation) are treated as disqualified individuals with respect to a corporation by reason of being officers.
 - (i) The number of employees is the greatest number of employees the corporation has during the disqualified individual determination period.
 - (ii) If the number of officers exceeds the limit, the highest paid 50 employees (or, if less, the greater of 3 employees, or 10% of the employees ranked on the basis of compensation during the disqualified individual determination period) are treated as officers.
 2. Highly-compensated individual. Q/A-19.
 - a. Any individual who is, or would be if the individual were an employee, a member of the group consisting of the lesser of the highest paid 1% of the employees of the corporation or the highest paid 250 employees, when ranked on the basis of compensation earned during the disqualified individual determination period.
 - b. The number of employees is the greatest number of employees the corporation has during the disqualified individual determination period.
 - c. The individual will not be treated as a highly-compensated individual if annualized compensation during the disqualified individual determination period is less than the Section 414(q)(1)(B)(i) amount (\$ 110,000 for 2011).
 3. Greater-than-1% shareholder. Q/A-17.
 - a. An individual who owns stock of the corporation with a fair market value that exceeds 1% of the fair market value of the

outstanding shares of all classes of the corporation's stock is treated as a disqualified individual.

- b. Section 318(a) constructive ownership rules apply in determining the amount of stock owned.
 - c. Stock underlying a vested option (including an option that vests upon the change in control) is considered owned by an individual who holds the vested option.
 - d. Stock underlying an unvested option is not considered owned by an individual who holds the unvested option.
4. "Disqualified individual determination period" is the 12-month period prior to and ending on the date of the change in control of the corporation. Q/A-20.
5. A director can be a disqualified individual if the director is an officer, highly-compensated individual, or 1% shareholder at any time during the disqualified individual determination period.
6. For purposes of determining who is an officer or highly compensated, compensation payable in the year of the change in control and contingent on the change is not treated as compensation. Q/A-21(c).
- D. "Change in ownership or control" comes in 3 flavors.
- 1. A *change in ownership* of a corporation occurs on the date that any one person, or more than one person *acting as a group*, acquires ownership of stock of the corporation that, together with stock held by such person or group, has more than 50% of the total fair market value or total voting power of the outstanding stock. Q/A-27(b).
 - a. Persons will not be considered to be acting as a group merely because they happen to purchase or own stock of the same corporation at the same time, or as a result of the same public offering.
 - b. They will, however, be considered to be acting as a group if they are owners of a corporation that enters into a merger or similar transaction with the corporation.
 - c. Overlap rule: if a person owns stock in both parties to a merger, such person is considered to be acting as a group with other shareholders in a corporation only with respect to the ownership in such corporation prior to the change-in-control transaction, and not with respect to the ownership interest in the other corporation.
 - d. The constructive ownership rules of Section 318(a) apply to determine stock ownership.
 - 2. A *change in effective control* of a corporation is *presumed* to occur on the date that any one person, or more than one person acting as a group, acquires 20% or more of the total voting power of the corporation during

any 12-month period, or a majority of the members of the board is replaced during any 12-month period by directors whose appointment or election is not endorsed by a majority of the members of the board prior to the date of the appointment or election. Q/A-28.

- a. The presumption may be rebutted by establishing that any such acquisitions, or such replacement of the majority of the board, does not transfer power to control the management and policies of the corporation from any one person or group to another person or group.
- b. The constructive ownership rules of Section 318(a) apply to determine stock ownership.

3. *A change in the ownership of a substantial portion of a corporation's assets* occurs on the date that any one person or group acquires in a 12-month period one-third or more of the total gross fair market value of the assets of the corporation. Q/A-29.

E. "Contingent" – a payment is treated as contingent on a change in ownership or control if the payment would not, in fact, have been made had no change in ownership or control occurred, even if the payment is also conditioned on the occurrence of another event. Q/A-22.

1. A payment generally is treated as one which would not, in fact, have been made in the absence of a change in ownership or control unless it is substantially certain, at the time of the change, that the payment would have been made whether or not the change occurred. Q/A-22(a).
2. A payment that becomes vested as a result of a change in ownership or control is not treated as a payment which was substantially certain to have been made whether or not the change occurred. A payment is vested if it is substantially vested within the meaning of Section 1.83-(3)(b) or the right to the payment is not otherwise subject to a substantial risk of forfeiture as defined by Section 83(c). Q/A-22(a).
3. A payment made pursuant to an agreement entered into within one year before the date of a change in control is *presumed* to be contingent on such a change unless the contrary is established by clear and convincing evidence. Q/A-25.
 - a. The same presumption applies to a payment made pursuant to an amendment that modifies an agreement in any significant respect within one year before the date of a change in control.
 - b. Only the portion of the payment that exceeds the amount that would have been paid in the absence of the amendment is presumed to be contingent on the change in control.
 - c. The presumption can be rebutted by clear and convincing evidence that the payment is not contingent on a change in control, but even if rebutted with respect to an agreement, payments under the

agreement may still be contingent on the change in control.
Q/A-26.

- (i) An agreement in the form of a nondiscriminatory employee plan or program specified in Q/A-26(c) will generally rebut the presumption.
 - (ii) A contract between a corporation and an individual that replaces a prior contract entered into by the same parties more than one year before the change in control, if the new contract does not provide for increased payments apart from normal increases attributable to increased responsibilities or cost of living adjustments, accelerate payments, or modify to the individual's benefit the terms or conditions under which the payments will be made will generally rebut the presumption.
 - (iii) A contract between a corporation and an individual who did not perform services for the corporation prior to the one-year period before the change in control, if the contract does not provide for payments that are significantly different in amount, timing, terms, or conditions from those provided under contracts entered into by the corporation with individuals performing comparable services (unless also entered into within one year before the change in control) will generally rebut the presumption.
4. A payment is treated as contingent on a change in control if the payment is contingent on an event that is *closely associated* with a change in control, a change in control actually occurs, and the event is *materially related* to the change in control. Q/A-22(b).
- a. A payment is treated as contingent on an event that is closely associated with the change in control unless it is substantially certain, at the time of the event, that the payment would have been made whether or not the event occurred.
 - b. An event is considered closely associated with the change in control if the event is of a type often preliminary or subsequent to, or otherwise closely associated with, a change in control.
 - (i) Voluntary or involuntary termination of the disqualified individual's employment.
 - (ii) A significant reduction in a disqualified individual's job responsibilities.
 - (iii) A change in ownership or control as defined in the disqualified individual's employment agreement or elsewhere that does not meet the Section 280G definition of change in ownership or control.

- c. An event is *presumed* to be materially related to a change in ownership or control if the event occurs within the period beginning one year before and ending one year after the date of the change in control.
- d. If the event occurs outside such two-year period, the event is *presumed not* materially related to the change in control.
- e. If a payment is contingent on a change in control or contingent on a closely associated event, it will still be treated as contingent on a change in control even if it is also contingent on the occurrence of a second event, without regard to whether the second event is closely associated with or materially related to a change in control. Q/A-22(b)(3).

Example. A contract between a corporation and B, a disqualified individual, provides that a payment will be made to B if the corporation undergoes a change in ownership or control and B's employment with the corporation is terminated at any time over the succeeding 5 years. Eighteen months later, a change in the ownership of the corporation occurs. Two years after the change in ownership, B's employment is terminated and the payment is made to B. Because it was not substantially certain that the corporation would have made the payment to B on B's termination of employment if there had not been a change in ownership, the payment is treated as contingent on the change in ownership. This is true even though B's termination of employment is presumed not to be, and in fact may not be, materially related to the change in ownership or control. Q/A-22(e), Example 2.

- f. If the time a payment is made is *accelerated* because of a change in control (or the occurrence of an event closely associated with and materially related to a change in control), the payment is treated as contingent on a change in control even if it would have been made in the absence of a change in control. The valuation of such accelerated payment is discussed in III. E, below. Q/A-22(c).
- g. Payments made pursuant to agreements entered into after a change in control are generally not treated as contingent on the change in control.
 - (i) However, an agreement executed after a change in control pursuant to a legally enforceable agreement entered into before the change is considered to have been entered into before the change. Q/A-23; Square D v. Commissioner, 121 T.C. 168 (2003).
 - (ii) If an individual has a right to receive a payment that would be a parachute payment if made under a pre-change agreement and gives up that right as bargained-for

consideration for benefits under a post-change agreement, the agreement is treated as a post-change agreement only to the extent the value of the payments under the agreement exceeds the value of the payments under the pre-change agreement. Q/A-23(a).

- F. “Base amount” – The average annual compensation paid by the corporation (or a predecessor entity or related entity) included in the disqualified individual’s gross income (Box 1/W-2 for an employee; Form 1099-MISC for an independent contractor or director) for the five (5) years prior to the year in which the change in control occurs (the “base period”). Q/A-34, Q/A-35.
1. If the base period includes less than a full year, the compensation for such year must be annualized.
 2. If the disqualified individual did not work for the corporation (or a predecessor or related entity) in each of the five years, such individual’s base period is the portion of such 5-year period during which the individual performed services for the corporation (or a predecessor or related entity). Q/A-35(a).
 3. Payments that would not be made more often than once a year are not annualized (e.g., sign-on bonus, relocation expenses).
 4. If the disqualified individual does not commence work for the corporation undergoing the change in control (or a predecessor or related entity) until the year in which the change in control occurs, such individual’s base amount is the annualized compensation for the pre-change portion of individual’s taxable year in which the change occurs that is not contingent on the change in control. Q/A-36.
- G. “Predecessor entity” – Any entity which, as a result of a merger, consolidation, purchase or acquisition of property or stock, corporate separation, or other similar business transaction, transfers some or all of its employees to the changed corporation or to a related entity, or to a predecessor entity of the changed corporation. Q/A-21(b).
- H. “Related entity” includes all members of a controlled group that includes the changed corporation or a predecessor entity, all trades or businesses (whether or not incorporated) that are under common control, and all members of an affiliated service group that includes the changed corporation or a predecessor entity. Q/A-21(b).
- I. Except as explicitly provided to the contrary in the Section 280G regulations, all members of the same affiliated group are treated as one corporation. Q/A-46.
- III. Mitigating provisions in the Section 280G regulations
- A. *Reasonable compensation for post-change services.*
1. A payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services to be rendered by the

disqualified individual *on or after* the date of the change in control is not a “parachute payment”. Q/A-9, Q/A-40, Q/A-41.

2. The determination of whether payments are reasonable compensation for personal services rendered or to be rendered by the disqualified individual is based on the facts and circumstances of the particular case. Relevant factors include:
 - a. The nature of the services rendered or to be rendered.
 - b. The individual’s historic compensation for performing such services.
 - c. The compensation of individuals performing comparable services in situations where the compensation is not contingent on a change in control.
3. Reasonable compensation for personal services includes reasonable compensation for holding oneself out as available to perform services and refraining from performing services (such as under a *covenant not to compete*).
4. The clear and convincing evidence standard that payments for post-change services are reasonable compensation would generally be met if all of the following statements are true (Q/A-42):
 - a. Payments are only for the period the individual actually performs services.
 - b. If the individual’s duties and responsibilities are substantially the same after the change in control, the individual’s annual compensation for such services is not significantly greater than such individual’s annual compensation prior to the change in control, apart from normal increases attributable to increased responsibilities or cost of living adjustments.
 - c. If the scope of the individual’s duties and responsibilities is not substantially the same, the annual compensation after the change is not significantly greater than the annual compensation customarily paid by the employer or by comparable employers to persons performing comparable services.
 - d. The individual must, in fact, perform the services contemplated in exchange for the compensation.
5. In the case of a *covenant not to compete*, the agreement must substantially constrain the individual’s ability to perform services and there must be a reasonable likelihood that the agreement will be enforced against the individual. In the absence of clear and convincing evidence to that effect, payments under the agreement will be treated as severance payments which are not treated as reasonable compensation.
Q/A-42(b), Q/A-44.

B. *Reasonable compensation for pre-change services.* Q/A-39.

1. The amount of an *excess* parachute payment is reduced by any portion of the payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered by the disqualified individual *before* the date of the change in control.
2. The portion of any parachute payment that is established as reasonable compensation for pre-change services must first be reduced by the portion of the disqualified individual's base amount that is allocated to such parachute payment.
3. Any remaining portion of the parachute payment established as reasonable compensation then reduces the excess parachute payment.

Example. Assume that a parachute payment of \$600,000 is made to a disqualified individual, and the portion of the individual's base amount that is allocated to the parachute payment is \$100,000. Also assume that \$300,000 (50%) of the \$600,000 parachute payment is established as reasonable compensation for personal services actually rendered by the disqualified individual before the date of the change in ownership or control. Before the reasonable compensation is taken into account, the amount of the excess parachute payment is \$500,000 (\$600,000-\$100,000). In reducing the excess parachute payment by reasonable compensation, the portion of the parachute payment that is established as reasonable compensation (\$300,000) is first reduced by the portion of the disqualified individual's base amount that is allocated to the parachute payment (\$100,000), and the remainder (\$200,000) then reduces the excess parachute payment. Thus, in this case, the excess parachute payment of \$500,000 is reduced by \$200,000 of reasonable compensation. Q/A-39(b), Example 1.

Example. Assume the same facts as above, except that 100% of the \$600,000 parachute payment is established as reasonable compensation. In this case, the excess parachute payment of \$500,000 is reduced to zero by \$500,000 of reasonable compensation. As a result, no portion of any deduction for the payment is disallowed by Section 280G, and no portion of the payment is subject to the 20-percent excise tax of Section 4999. Q/A-39(b), Example 2.

4. The discussion in III. A. 2, 3, 4, above, relating to the determination of whether post-change payments constitute reasonable compensation is also applicable to payments for pre-change services. See also, Square D v. Commissioner, 121 T.C. 168 (2003); Balch v. Commissioner, 100 T.C. 331 (1993); Cline v. Commissioner, 34 F.3d 480 (1994).
5. The amount of any payment treated as contingent on a change in control by reason of the *acceleration* of the time at which the payment is made or vests under the rules discussed in III. E, below, may not be reduced by reasonable compensation. Q/A-24(a)(2).

C. A payment to a disqualified individual with respect to a corporation which immediately before the change in ownership or control would qualify as a *small*

business corporation as defined in Section 1361(b) is not a parachute payment. Q/A-6(a)(1).

1. This exception to parachute payment treatment applies without regard to whether the corporation actually elected S status.
2. The determination of whether the corporation is a small business corporation is made without regard to whether the corporation has a non-resident alien as a shareholder.

D. In the case of *non-publicly traded corporations* (i.e., no stock in the corporation was readily tradeable on an established securities market or otherwise), a payment will not constitute a parachute payment if the *shareholder approval* requirements described in III. D. 3, below, are met. Q/A-6(a)(2).

1. This exception to parachute payment treatment does not apply with respect to a corporation if a substantial portion of the assets of any entity consists (directly or indirectly) of stock in such corporation and any ownership interest in such entity is readily tradeable on an established securities market or otherwise.
 - a. Stock constitutes a substantial portion of the assets of an entity if the total fair market value of the stock is equal to or greater than one-third of the total gross fair market value of all of the assets of the entity.
 - b. Gross fair market value means the value of the assets of the entity determined without regard to any liabilities associated with such assets.
2. If a corporation is a member of an affiliated group (which group is treated as one corporation under Q/A-46), the requirements for this exception are not met if any stock in any member of the group is readily tradeable on an established securities market or otherwise.
3. Shareholder approval requirements. Q/A-7.
 - a. *Vote required:* the payment must be approved by more than 75% of the voting power of all outstanding stock of the corporation entitled to vote immediately before the change in ownership or control. Q/A-7(a)(1).
 - (i) The vote must determine the right of the disqualified individual to receive the payment, or, in the case of a payment made before the vote, the right of the disqualified individual to retain the payment.
 - (ii) Generally, the normal voting rules of the corporation are applicable (an optionholder is not permitted to vote).
 - (iii) The vote can be on less than the full amount of the payments to be made.

- (iv) Shareholder approval can be a single vote on all payments to any one disqualified individual or on all payments to more than one disqualified individual.
- (v) The total payments submitted for shareholder approval must be separately approved by the shareholders.
- (vi) Approval of the change in control must not be contingent or otherwise conditioned on approval of any payment to a disqualified individual that would be a parachute payment but for this shareholder approval exception.
- (vii) A vote will not fail to be a vote of the outstanding stock of the corporation entitled to vote immediately before the change in ownership or control merely because the determination of the shareholders entitled to vote on the payment is based on the shareholders of record as of any day within a six-month period immediately prior to and ending on the change in control date.
- (viii) Approval of a payment by an *entity shareholder* must be made by the person authorized by the entity shareholder to approve the payment.
 - (A) If a substantial portion of the assets of an entity shareholder consists of stock in the corporation undergoing the change in control, approval of the payment by that entity shareholder must be made by a separate vote of the persons who hold, immediately before the change in control, more than 75% of the voting power of the entity shareholder entitled to vote.
 - (B) The foregoing rule does not apply if the value of the stock of the corporation owned by the entity shareholder does not exceed 1% of the total value of the outstanding stock of the corporation undergoing the change in control.
 - (C) Where approval of a payment by an entity shareholder must be made by a separate vote of the owners of the entity shareholder, the normal voting rules of the entity shareholder determine which owners vote.
 - (D) Stock represents a substantial portion of the assets of an entity shareholder if the total fair market value of the stock held by the entity shareholder in the corporation undergoing the change in control is equal to or exceeds one-third of the total gross fair market value of all of the assets of the entity shareholder.

- (ix) To determine which persons are entitled to vote, stock that would otherwise be entitled to vote is not counted as outstanding stock and is not considered in determining whether the more than 75% vote has been obtained if the stock is actually or constructively owned (under the section 318(a) attribution rules) by or for a disqualified individual who receives (or is to receive) payments that would be parachute payments if the shareholder approval requirements were not met.
 - (A) Stock is not counted as outstanding stock if the owner is considered under the constructive ownership rules of Section 318(a) to own any part of the stock owned directly or indirectly by or for a disqualified individual.
 - (B) If the person authorized to vote the stock of an entity shareholder is a disqualified individual who would receive a parachute payment if the shareholder approval requirements were not met, such a person is not permitted to vote such shares, but the entity shareholder is permitted to appoint an equity interest holder in the entity shareholder to vote the otherwise eligible shares.

b. *Adequate disclosure.* Q/A-7(c).

- (i) To be adequate disclosure, the disclosure must be full and truthful disclosure of the material facts and such additional information as is necessary to make the disclosure not materially misleading at the time the disclosure is made.
- (ii) The disclosure must be made to every shareholder of the corporation entitled to vote determined after application of III. D. 3. a. ix, above.
- (iii) For each disqualified individual, material facts that must be disclosed include:
 - (A) The event triggering the payment or payments;
 - (B) The total amount of the payments that would be parachute payments if the shareholder approval requirements were not met.
 - (C) A brief description of each payment (e.g., accelerated vesting of options, bonus or salary).
- (iv) An omitted fact is considered a material fact if there is a substantial likelihood that a reasonable shareholder would consider it important.

E. *Accelerated payments*: special rules are prescribed to value payments that are treated as contingent on a change in control because the change accelerates the time at which the payment is made or vests. Q/A-24(b).

1. The amount of a *vested* payment that is treated as contingent on the change in control because the change accelerates the time at which the payment is made is the amount by which the accelerated payment exceeds the present value of the payment absent the acceleration.

a. If the value of such a payment absent the acceleration is not reasonably ascertainable, and the acceleration of the payment does not significantly increase the present value of the payment absent the acceleration, the present value of the payment absent the acceleration is treated as equal to the amount of the accelerated payment.

Example. As a result of a change in the effective control of a corporation, D, a disqualified individual with respect to the corporation, receives accelerated payment of D's vested account balance in a nonqualified deferred compensation account plan. Actual interest and other earnings on the plan assets are credited to each account as earned before distribution. Investment of the plan assets is not restricted in such a manner as would prevent the earning of a market rate of return on the plan assets. The date on which D would have received D's vested account balance absent the change in ownership or control is uncertain, and the rate of earnings on the plan assets is not fixed. Thus, the amount of the payment absent the acceleration is not reasonably ascertainable. Under these facts, acceleration of the payment does not significantly increase the present value of the payment absent the acceleration, and the present value of the payment absent the acceleration is treated as equal to the amount of the accelerated payment. Accordingly, no portion of the payment is treated as contingent on the change.

b. If the value of the payment absent the acceleration is not reasonably ascertainable, but the acceleration significantly increases the present value of the payment, the future value of such payment is treated as equal to the amount of the accelerated payment.

c. The acceleration of the vesting of a stock option or the lapse of a restriction on restricted stock is considered to significantly increase the value of a payment. Q/A-24(c)(3).

2. *Nonvested payments*.

a. If, without regard to a change in control, a payment is contingent only on the continued performance of services for the corporation for a specified period of time and the payment is attributable, at least in part, to the performance of services before the payment vests, the amount of the payment treated as contingent on the

change in control is the amount described in III. E. 1, above, for vested payments, plus an amount to reflect the lapse of the obligation to continue to perform services.

- b. The amount reflecting the lapse of the obligation to continue to perform services is 1% of the amount of the accelerated payment multiplied by the number of *full months* between the date that the individual's right to receive the payment vests and the date that, absent the acceleration, the payment would have vested. Q/A-24(c)(4).
- c. The amount of the payment treated as contingent on the change in control cannot exceed the amount of the accelerated payment, or, if the payment is not accelerated, the present value of the payment. Q/A-24(c)(2).
- d. If the vesting of the payment is accelerated, but the time at which the payment is made is not accelerated, the amount reflecting the lapse of the obligation to continue to perform services is 1% of the *present value* of the future payment multiplied by the number of full months between the date that the individual's right to receive the payment vests and the date that, absent the acceleration, the payment would have vested. Q/A-24(c)(4).

Example. (i) On January 15, 2006, a corporation gives to a disqualified individual, in connection with her performance of services to the corporation, a bonus of 1,000 shares of the corporation's stock. Under the terms of the bonus arrangement, the individual is obligated to return the stock to the corporation if she terminates her employment for any reason prior to January 15, 2011. However, if there is a change in the ownership or effective control of the corporation prior to January 15, 2011, she ceases to be obligated to return the stock. The individual's rights in the stock are treated as substantially nonvested (within the meaning of §1.83-3(b) and (j)) during that period. On January 15, 2009, a change in the ownership of the corporation occurs. On that day, the fair market value of the stock is \$500,000.

(ii) Under these facts, the payment was contingent only on performance of services for a specified period and is attributable, in part, to the performance of services before the change in ownership or control. Thus, only a portion of the payment is treated as contingent on the change in ownership or control. The portion of the payment that is treated as contingent on the change is the amount by which the present value of the accelerated payment on January 15, 2009 (\$500,000), exceeds the present value of the payment that was expected to have been made on January 15, 2011, plus an amount reflecting the lapse of the obligation to continue to perform services. At the time of the change, it cannot be reasonably ascertained what the value of the stock would have been on January 15, 2011. The acceleration of the lapse of a restriction on stock is treated as

significantly increasing the value of the payment. Therefore, the value of such stock on January 15, 2011, is deemed to be \$500,000, the amount of the accelerated payment. The present value on January 15, 2009, of a \$500,000 payment to be made on January 15, 2011, is \$406,838. Thus the portion of the payment treated as contingent on the change is \$208,162, the sum of \$93,162 (\$500,000-\$406,838), plus \$115,000 (1 percent x 23 months x \$500,000), the amount reflecting the lapse of the obligation to continue to perform services.

3. The foregoing rules do not apply to a payment if, without regard to the change in control, vesting of the payment depends on an event other than the performance of services, such as the attainment of a performance goal, and the event does not occur prior to the change in control.
 - a. In such case, the full amount of the accelerated payment is treated as contingent on the change in control.
 - b. However, the amount of the excess parachute payment could be reduced by the portion of the payment which is established to be reasonable compensation for personal services actually rendered before the date of the change in control. See III. B, above.
4. The present value of a payment is determined as of the date on which the accelerated payment is made.
5. The IRS has interpreted “full months” in the 1% per month lapse of obligation to perform services calculation to mean full *calendar* months. See PLR 9608020, which is consistent with Examples 3 and 4 in Q/A-24(f).
6. The special rules that treat only a portion of a payment as contingent on a change in control because of acceleration of the time a payment is made or vests (i.e., less than the full amount of the payment) do not apply to any payment presumed to be contingent on the change in control because made pursuant to an agreement entered into within one year before the date of a change in control, unless the presumption is rebutted. Q/A-24(a)(l). See II. E. 3, above.

F. *Present value* considerations.

1. Generally, the present value of a payment is determined as of the date on which the change in control occurs, or, if a payment is made prior to such date, the date on which the payment is made. Q/A-31(a).
2. Present value is generally determined by using a discount rate equal to 120% of the applicable federal rate compounded semi-annually. Q/A-32.
 - a. The AFR to be used is the rate in effect on the date as of which the present value is determined, using the period until the payment would have been made without regard to the change in control as the term.

- b. However, for any payment, the corporation and the disqualified individual may elect to use the AFR in effect on the date that the contract which provides for the payment is entered into, if such election is made in the contract.
 - c. The IRS issues a revenue ruling monthly setting forth the AFRs for the following month based on the yield to maturity of outstanding marketable obligations of the United States of similar maturities during the one month-period ending on the 14th day of the month preceding the month for which the rates are applicable. For June 2011, 120% of the AFRs, compounded semiannually, for short-term (≤ 3 years), mid-term (>3 years and ≤ 9 years), and long-term (> 9 years) are .55%, 2.71%, and 4.81%, respectively. Rev. Rul. 2011-13 (Table 1).
3. In some cases when it is necessary to make calculations under the Section 280G regulations (e.g., to apply the 3 times base amount test or to allocate a portion of the base amount to a payment), the aggregate present value of payments cannot be determined with certainty because the time, amount or right to receive one or more such payments is contingent on the occurrence of an uncertain future event or condition. Q/A-33.
- a. If it is reasonably estimated that there is a 50% or greater probability that the payment will be made, the full amount of the payment is considered for purposes of the 3 times base amount test and the allocation of the base amount.
 - b. Conversely, if it is reasonably estimated that there is a less than 50% probability that the payment will be made, the payment is not considered for either purpose.
- Example. A disqualified individual's right to receive a payment may be contingent on the involuntary termination of such individual's employment with the corporation.
- c. If the estimate is later determined to be incorrect, the 3 times base amount test must be reapplied (and the portion of the base amount allocated to previous payments must be reallocated, if necessary, to such payments) to reflect the actual time and amount of the payment.

IV. Contractual remedies often found in Employment or Change in Control Agreements

- A. *Straight cutback.* If a disqualified individual would otherwise receive payments that equal or exceed 3 x base amount, the amount of such payments will be cut back to \$1 less than 3 x base amount (or cut back to 2.99 x base amount).
- B. *Limited cutback or maximization cutback.* If a disqualified individual would otherwise receive payments that equal or exceed 3 x base amount, the amount of such payments will be cut back such that the disqualified individual receives \$1 less than 3 x base amount (or 2.99 x base amount) if he is better off on an after-

tax basis by being cut back. If, on the other hand, the amount of the cutback necessary to so reduce his payments is greater than the 20% excise tax on the excess parachute payments plus the income tax that the disqualified would be required to pay on the cutback amount, he would not be cut back. A slight modification to such a limited cutback might build in a threshold amount (e.g., \$25,000 or 110% of the sum of the excise tax on the excess parachute payments and the income tax imposed on the cutback amount) by which the disqualified individual's lot must be improved to avoid being cut back.

- C. *Gross-up payment.* If a disqualified individual would otherwise receive payments that equal or exceed 3 x base amount, the disqualified individual is entitled to receive a gross-up payment such that after payment of the income tax and the 20% excise tax with respect to such gross-up payment, the disqualified individual will have enough of the gross-up payment left to pay the 20% excise tax on excess parachute payments to which the disqualified individual would have been subject had he not received the gross-up payment.
1. A gross-up payment will generally be quite expensive to the payor corporation because the corporation will be out-of-pocket for the gross-up payment *and* will lose the tax deduction for all payments in excess of the disqualified individual's base amount.
 2. Computation of the amount of a gross-up payment creates an interesting iterative calculation for the tax advisor if one or more payments (or portions thereof) are considered reasonable compensation for services rendered prior to the change in control. See III. B, above.