# Commentary

## Golden Parachute Tax Rules In A Venture Capital Context: Early Stage Structures Can Create Tax Hits Upon Exit

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Many venture-backed companies first learn the golden parachute tax rules at some point during a sale of the company. This is too late. Entrepreneurs and their investors should learn these rules when they first invest or document employment arrangements, because they could subject the company and its executives to significant tax penalties upon a change in control, which includes not only a traditional sale of the company, but also potentially a significant new investment in the company.[1]

### The Fact Pattern

We'll consider two distinct outcomes. In outcome one, the venture-backed start-up of yesterday is selling to a strategic buyer and the investors will reap eight times their investment. In outcome two, the company has not done as well as everyone had hoped and the sale will return less than the investment to the VCs and will trigger a management carve out.[2] In either case, the company's counsel or financial officer calls to tell you that, unfortunately (and what is worse, unexpectedly), the company's substantial golden parachute payments are not deductible and will dampen investor returns. In addition, the recipients of the golden parachute payments will have to pay large penalty taxes, meaning that a substantial portion of these nondeductible payments will go to the government rather than to the executives who grew the company (or, alternatively, who need the incentive). You immediately recognize that this will cause a last minute negotiation with the management team about whether the company will make the team whole on the personal tax liability — this is clearly a negotiation in which the investors' interests are misaligned with those of the team — a sub-optimal result from a number of perspectives. As you begin to understand how you got here, you realize that with some thoughtful planning, the company could have avoided this.

### Background

Golden parachute payments are large payments a company makes to certain personnel upon a change in control of the company (an IPO, sale of the business, or a significant new investment). The rules apply to agreements to make those payments, regardless of whether the Company and the executives agreed upon them early in the life of the company or at the time of the change in control. These payments are critical for attracting and retaining senior management at venture-backed businesses, especially because the executives driving the company to the triggering transaction know that they may not have a long-term role within the buyer's organization.

In enacting the rules, Congress believed that these large payments adversely impact corporate shareholders because the payments, for example, could hinder or reduce the purchase price of acquisitions. Note that Congress enacted these rules generally in response to golden parachute payments paid by public companies, where shareholders have little to no control over the day-to-day operations of the company. To create this disincentive, Congress expressly barred the tax deductibility of these payments (the tax code generally provides that corporations may deduct compensation expenses) while imposing on the recipient a 20-percent penalty tax that the company must withhold at the time of payment. Companies that fail to consider these rules may trigger large, unexpected costs to both the company and executives at the time the company is sold, goes public, or receives a new investment.

What can really surprise venture backed companies is that acquiring only 20 percent of a company's stock may well trigger the golden parachute rules (this is discussed in more detail later in the article). For instance, a substantial increase in the salary of an executive upon receiving additional financing (an event not generally thought of as a sale of the company) can also trigger the golden parachute rules.[3] While obtaining shareholder approval may protect you from the harsh effects of the golden parachute rules in certain situations (also discussed later in the article), it illustrates how important it is for parties involved in these deals to consider the golden parachute rules any time that a company changes an executive's salary or pays compensation that is related to the acquisition of company stock, even if the parties do not think of the transaction as a sale of the company.

## Brief Summary Of The Golden Parachute Rules

When a company makes a "parachute payment" to a "disqualified individual," the company is barred from taking tax deductions, and the disqualified individual personally is subject to a 20-percent penalty tax on the portion of the payment treated as an "excess parachute payment." In general, the rules define a "disqualified individual" as an employee or independent contractor who fits one of the following descriptions: (1) a shareholder owning at least 1 percent of the value of the corporation; (2) an officer (including personnel without the title but with the authority of an officer); or (3) a "highly-compensated individual," defined as any member of the group consisting of either (a) the highest paid 1 percent of the employees of the company, or (b) the 250 highest paid employees of the company, whichever group is smaller. The rules will not apply to individuals receiving less than a certain amount ($100,000 for 2006).

A payment to a disqualified individual is described as a "parachute payment" if:

(1) the payment is in the nature of compensation for services;[4]

(2) the payment is contingent on a change in the ownership of the company (defined generally as the acquisition of more than 50 percent of the fair market value or voting power of the stock of the company[5]), or in the "effective control" of the company. Note that the IRS will presume that there is a change in control if (a) a person or persons acting in concert[6] acquire 20 percent or more of the voting power or (b) a majority of the board of directors is changed by persons not endorsed by a majority of the previous board; and

(3) the payment has, together with other payments, an aggregate present value of at least three times the individual's "base amount" — the individual's average annual compensation for services performed for the company during the 5 years before the change in control (this 5-year period is adjusted for employees with shorter tenures).[7]

A "payment" for purposes of these rules encompasses much more than cash. It can include virtually any type of payment in the nature of compensation arising out of the employment relationship, including severance pay, fringe benefits, pensions, and other deferred compensation, whether paid in cash or in property, such as stock or stock options.

Unless an exemption applies, an "excess parachute payment" (the portion of the parachute payment that is nondeductible and subject to the penalty) is the difference between the total amount of the parachute payment and the individual's "base amount." For those well versed in the ways of the IRS, it will come as no surprise to learn that the rules use "base amount" in two different and confusing ways: (1) when determining whether the rules apply to a given payment, the IRS test is whether the payment exceeds three times the individual's "base amount," and (2) when determining the portion of the parachute payment to which the penalties will apply, the IRS includes anything in excess of one times the "base amount." This means, for instance, that if an executive's average annual compensation for the 5 years preceding a sale of the company is $200,000, and the company pays the executive a $900,000 change in control bonus, the excess parachute payment is $700,000 (not $300,000, which is the amount in excess of three times the base amount). The rules permit a taxpayer to reduce the amount the IRS would otherwise deem to be an "excess parachute payment" to the extent that the taxpayer "clearly and convincingly" establishes that the payment constitutes "reasonable compensation" for services rendered or to be rendered.[8]

As the above summary illustrates, the golden parachute rules contain a number of different tests and the tax code's typically stilted jargon, making it even more imperative to exercise care when navigating these rules. Fortunately, planning may enable you to minimize the impact of the parachute rules.

We discuss below some of the golden parachute triggers that people most commonly overlook and provide some suggestions to diminish the pain these rules can inflict. However, a company must consider these suggestions early in its life — most of these will not help much when you are at the closing table about to exchange signature pages to consummate the merger or venture capital investment.

### Compensation Increases And Reductions (Including Compensation Increases Upon Receipt Of New Investment)

As mentioned earlier, a substantial increase in an executive's compensation upon a new financing (from outside investors or current shareholders) might implicate the golden parachute rules. Even though the parties may not think of the transactions as a sale of the company, if the investors acquire 20 percent of the voting power of the stock or choose a majority of the board of directors, then the tax law presumes a change in control. In that instance, the compensation increase may trigger the golden parachute tax rules if the increase exceeds three times the executive's average annual compensation for the prior five years (the "base amount" discussed earlier). While this may not sound widely applicable, consider whether the management team took little or no compensation in the early years and how that would impact the five year average, especially if the increase in compensation is designed to make the team whole for years of under compensation. Therefore, it makes sense to consider whether provisions for large compensation increases could trigger the golden parachute rules.[9]

To rebut the presumption that the rules apply, the company or executive must show that the investment does not transfer the power to control the management of the company from one person or group to another person or group. The regulations do not provide much guidance on the issue. In a recent private letter ruling[10] involving a more than 20-percent investment, the IRS ruled that the taxpayer successfully rebutted the presumption in light of the following factors: (1) there was substantial stock ownership remaining with the founders and current management; (2) the buyer's interest would fall under 20 percent in a relatively short period of time due to dilution as company employees exercised options that had been granted prior to the closing; (3) none of the buyer's shareholders or management held positions with the company;[11] (4) the buyer's acquisition was consistent with that of an institutional investor; and (5) the company competed in the marketplace with other businesses owned or invested in by the buyer.[12]

Note that these factors do not necessarily have to be present to rebut the presumption. The standard for obtaining a formal IRS ruling most likely is higher than the actual, legal standard.

Sometimes an increase in an executive's compensation in anticipation of a future change in control can help minimize or even avoid the impact of the golden parachute rules. The parties can accomplish this without even increasing an executive's salary, such as through an executive's exercise of nonqualified stock options in the year prior to a change in control which, like an increase in salary, increases the executive's "base amount." In some circumstances, a small increase in compensation could avoid major penalties. For example, take the case of an executive with a $200,000 average annual compensation for the five years prior to a change in control who received a change in control payment of $600,000. The IRS would treat that executive as having received an excess parachute payment of $400,000, which would not be deductible to the company and which would result in an $80,000 penalty tax to the executive. However, if the Company had increased that executive's compensation by one dollar in year 4, the base amount would have increased to more than $200,000, and the excess parachute payment would have been zero.[13] Deal teams may find this strategy particularly useful when working on a deal that will close in the calendar year after the deal began.

A company going through a lean early year may decide to reduce the salaries of executives, especially if the executives stand to have a big up-side on a sale of the company. This salary decrease may later help trigger the golden parachute rules, because it reduces the "base amount." Note that if the executive works as a lower-paid consultant or director prior to becoming an executive, the prior work counts as part of the five-year period used in calculating the base amount.

### Exceptions For Certain Small Corporations And Companies Not Organized As Corporations

The golden parachute rules do not apply to corporations eligible to file elections to be treated as S corporations, regardless of whether the corporation and its shareholders have elected S-corporation treatment. This means that, under the current requirements for qualification as an S corporation, the parachute rules generally will not apply to any domestic corporation where the corporation has one class of stock (although that class may be divided into voting and nonvoting shares) and has 100 or fewer shareholders, provided that each shareholder is both an individual (or certain qualified trusts). The usual rule that a corporation cannot qualify as an S corporation if it has a nonresident alien shareholder does not apply for purposes of this exception to the golden parachute rules. Obviously, this rule will not help most venture-backed companies, because venture-backed businesses generally (1) have stockholders that are limited partnerships or other entities and (2) issue preferred stock to their investors.

In addition, companies that are not corporations for tax purposes (such as most limited liability companies and partnerships)[14] are not subject to the golden parachute rules. While this may factor into the choice of entity for some start-ups, the aversion venture capital funds have to investing in vehicles other than Delaware C corporations also makes this of little help to most early stage companies. For those who may start life as a corporation and decide to switch to the LLC or partnership vehicle to avoid this problem later, note that the IRS treats as a taxable transaction the conversion from a corporation to a limited liability company or a partnership.

### Shareholder Approval Exception For Non-Public Companies

The golden parachute rules exempt corporations that are not publicly traded if (1) the shareholders receive adequate disclosure and (2) the shareholders who owned, immediately before the change in control, more than 75 percent of the voting power of the stock, affirmatively approved the payment at issue. The IRS does not count stock of the disqualified individual (or certain related persons, such as members of the individual's family and certain entities in which the individual or family members have an interest) in this determination. This means that 75 percent of the voting power of the company's stock other than the disqualified individual's stock must approve in order to satisfy the shareholder approval requirement. However, if all persons who hold voting power are disqualified individuals (or certain related persons), then their stock is counted and can be voted to satisfy the shareholder approval requirement. While the rules permit the vote to occur after the change in control, approval must be received by those persons who immediately before the change in control owned more than 75 percent of the voting power. The rules provide some flexibility in that the company may choose any day within the six-month period ending on the change-in-control date as the record date for determining which shareholders' votes count.[15]

The problem then becomes the adequacy of the disclosure on which those shareholders base their votes. The rules borrow from the securities laws to require that the disclosure must include the material facts and additional information necessary so that it is not materially misleading at the time it is made. At a minimum, the disclosure must identify the individuals entitled to the payment, the event triggering the payment, and the type and amount of the payment (or formula and sufficient information to permit the shareholder to ascertain its amount or value).[16]

Payments under change in control agreements can qualify under the "shareholder approval" exception even if the company obligates itself to make those payments to executives long before the change in control. However, in order for the exception to be effective, the individual probably must agree to relinquish the right to receive the payments if the shareholder approval requirement is not satisfied close in time to the date of the change in control payment. Of course, the executive may doubt the adequacy of the incentive because she or he knows that, should the shareholders (whoever they may be at the time of sale) fail to approve the bonus, the executive will have to forego the compensation.

If the corporation attempts to take the vote at the time it confers upon the executive the right to the change in control bonus, the "adequacy of disclosure" prong may become an insurmountable hurdle unless the parties have definitively determined the payment amount or provided a formula that makes very clear and calculable the amount of the payment, and even then a "material" fact may arise between the time of the shareholder approval and the time of the payment rendering the approval inadequate. Of course, should the parties change the terms once the corporation has obtained approval, the corporation would then have to start the disclosure and approval process anew. In addition, approval at the time of adopting the bonus obligation may also fail where later changes in the composition of the shareholders would necessitate a new disclosure and approval process at the time of the change in control.[17]

## Timing Of The Change In Control Agreement

The IRS has, in regulations, articulated that it will presume that any payment under an agreement entered into or amended within one year before a change in control is contingent on that change in control, absent clear and convincing evidence to the contrary.[18] The regulations describe the operative date as the date the buyer or investor triggering the change in control closes rather than merely signs the acquisition of stock or assets. In light of this presumption, companies and employees should ink agreements that might be treated as containing change in control payments as early as possible with a formula or other compensation arrangement that predicts the future in a way that balances creating an appropriate incentive for the management team and avoiding over-compensating them.[19]

## Vesting

The vesting of restricted stock and, in limited cases, options, can also trigger the golden parachute rules. Explaining how this works requires a little background in how individuals are taxed. Individuals generally are "cash-based" taxpayers, which means that they incur tax liability on the day on which they receive cash or non-cash property (such as stock) as compensation. In contrast, however, individuals do not generally incur tax liability on non-cash property on the day they receive it when the right to own that property vests over time. Rather, the IRS imposes tax liability as of the day the property vests (in other words, on the day when the property is no longer subject to a "substantial risk of forfeiture"). For example, it would not be unusual for a start-up to grant restricted stock to an executive. Let's assume the start-up grants stock with the following terms: the executive forfeits the stock if he or she leaves before the end of a four year term, but some or all of the vesting accelerates[20] upon a change in control. In this situation,[21] because the restrictions lapsed in the year of the acceleration, the golden parachute rules would apply to that payment, assuming the dollar amounts were large enough. The amount of the payment would equal the fair market value of the stock that vested on the given vesting date (in this case, the stock that vested at the change in control). The IRS treats stock options the same way even though the vesting of a stock option generally is not a taxable event.[22] The IRS has published guidance describing acceptable methods of valuing stock options for tax purposes, including the Black-Scholes model.

If, at the time of the change in control, the executive already had a vested right to receive a payment at some future point, but the change in control accelerated the timing of payment, then the IRS will generally deem the amount contingent on the change in control to be the net present value of having received the payment sooner than was scheduled (rather than the full value of the payment).

The following techniques can, however, reduce the value of the equity payment which may, in some cases, take the payment out of the parachute category (by preventing the amount of the payment from exceeding three times the executive's base amount). The IRS will not deem the equity to be part of a parachute payment to the extent that (1) the payment hinges only on the continued performance of services (which is the most common vesting condition) rather than the change in control, and (2) the payment is attributable, at least in part, to the performance of services before the date that the payment is made or becomes certain to be made. As if these rules were not complex enough, the IRS has included a cumbersome formula for these situations. In these cases, the rules provide that the amount treated as contingent on a change in control generally is the amount by which the accelerated payment exceeds the present value of the payment absent acceleration, plus 1 percent of the amount of the accelerated payment for each month that the payment was accelerated.[23]

In addition, there may be some room for creative planning if the payment takes the form of stock options, because the IRS will assess the value of the options (as of the date of grant or vesting) based on all of the relevant facts and circumstances. As mentioned, the IRS specifically allows valuation based on the Black-Scholes model, which takes into account factors such as the volatility of the underlying stock; the exercise price of the option; the value of the stock at the time of valuation; and the term of the option on the valuation date. For example, an option grant could require that, upon a change in control, the term of the option is reduced. A shorter option term would reduce the value of the option at the time of the change in control, because under Black-Scholes and other methods, the term of the option correlates directly with its value.

If a change in control is anticipated relatively early in the life of the company, it might make sense to have earlier vesting with no acceleration on a change in control, or in the case of stock options, to incorporate provisions (such as an automatic reduction of the term of the option on a change in control), that could reduce the property's value. However, the risk of violating the golden parachute rules has to be weighed against the impact of those terms on the company's ability to retain key executives.

## Other Techniques For Avoiding Or Mitigating The Impact Of The Golden Parachute Rules

There are some additional techniques that can prevent or mitigate the effect of the golden parachute rules. First, the company's change in control payments can have caps designed to ensure that the payments are not excess parachute payments. For instance, the change-in-control agreement can provide that if the change-in-control payment would exceed three times the executive's base amount, then the payment would be reduced so that the penalties would not apply. Note that, because "payments" for this purpose include more than cash (such as taxable fringe benefits),[24] capping the cash change in control payment at 2.99 times the base amount may not be sufficient to avoid application of the golden parachute rules.

Another possible approach would be for the company to "gross up" the executive — to pay the executive enough to cover the executive's 20-percent penalty tax. A gross-up, however, while making the executive whole, would not prevent the golden parachute rules from acting to disallow a deduction for the company. In addition, gross-up payments can be very costly. For example, for an executive who has average annual compensation of $200,000 and a change-of control payment of $900,000, the gross-up amount would be (assuming a 45% combined federal and state tax rate) $400,000. That is, the corporation would have to pay the executive $1,300,000 in order for the executive to end up with the desired pre-tax change in control payment amount of $900,000. Moreover, from an accounting perspective the change to earnings could make this particularly undesirable for public companies.

A third approach would be to pay the executive the maximum amount that could be paid without triggering an excise tax or the full amount of the parachute payments, whichever results in the executive receiving the maximum amount of after-tax dollars.

## Conclusion

As this overview illustrates, there are several things that a company, its executives and investors should consider long before a change in control occurs in order to plan for, and to the extent possible, around the golden parachute rules. These include choice of entity; whether to issue preferred stock; shareholder approval of change in control payments; the timing of change in control agreements; the timing of vesting and exercise of stock or stock options; the terms of stock options; major salary reductions and increases; and whether to have caps or gross-up arrangements. An awareness of the rules could help avoid the all too common experience of unknowingly triggering the golden parachute rules and early planning may pay off in significant tax savings.

## Endnotes

1. While this article uses the term "company" throughout, the golden parachute rules apply only to corporations not eligible to file S-corporation elections. The rules do not apply to corporations eligible to file S-corporation elections and entities not taxed as corporations, such as most limited liability companies and partnerships.

2. A venture-backed company implements a "management carve out" or "out of turn payment plan" to provide extra consideration to the management team in the event that the company will be sold for an amount that would otherwise not yield a rich enough incentive for the management team. In order to keep the team motivated and engaged in the company, as well as providing an additional incentive to consummate a proposed deal, carve outs have become popular post bubble-burst. Carve outs are particularly critical in transactions in which key management will not retain their jobs, and the sale proceeds will not exceed the "liquidation preference" due to the investors. In that case, the payment to management is literally *carved out* from the liquidation preference. "Liquidation Preference" is the return paid to holders of preferred stock in a liquidation or sale of the business before shareholders receive sale proceeds paid in respect of the common stock.

3. This can happen not only from an outside investment, but also if existing shareholders acquire additional stock.

4. Note that in a venture round in which the founders (who happen to be continuing management) sell their shares for fair market value, the IRS should not treat the payment as compensation for services. Of course, if the payment exceeds the fair market value of the shares, the IRS might argue that the excess constitutes compensation.

5. Payments contingent on a change in the ownership of a substantial portion of the assets of the company also are subject to the golden parachute rules. In fact, in Yocum v. United States, 66 Fed. Cl. 579 (2005), the court held that the contribution of a company's assets to a joint venture would be treated as such a change in ownership for purposes of the golden parachute rules.

6. Persons are not considered to be "acting in concert" merely because they happen to purchase stock of the same corporation at the same time. However, persons will be considered acting together if they own a corporation that enters into a merger or purchase transaction with the company. Parties to a transaction should evaluate carefully whether a group of investors who will acquire at least 20 percent of a company in the aggregate might be treated as acting in concert to gain effective control of the company.

7. If the individual did not work for the company for the entire five-year period, only the years worked are counted. The IRS will annualize compensation for a partial year.

8. Reasonable compensation for past services is still included in calculating whether the parachute payment exceeds the base amount. The reasonable portion of the payment is then subtracted from any excess parachute payment. But note that the IRS disregards reasonable compensation for future services when determining whether a parachute payment exceeds the base amount.

9. The acceleration of deferred compensation upon an investment also can implicate the golden parachute rules, but only the portion of the payment that reflects the amount by which the amount of the accelerated payment exceeds the present value of the payment absent the acceleration (assuming that value is reasonably ascertainable). An acceleration

of vesting may also implicate these rules (this is discussed later in the article).

10. Private letter rulings are not binding on the IRS for taxpayers other than those seeking the ruling, but they are useful in determining the IRS's likely approach to a situation.

11. The buyer obtained the right to designate less than a majority of the board of directors.

12. Apparently, the fact that the company competed with other businesses in which the buyer was invested indicated that the buyer's acquisition was consistent with that of an institutional investor.

13. You arrive at this counter-intuitive result because the $600,000 payment would have been less than three times the "base amount" which would have increased to $200,000.20.

14. Examples of noncorporate entities that are treated as corporations and thus are subject to the golden parachute rules include partnerships classified as "publicly traded partnerships" and partnerships that have elected under the so-called "check-the-box" rules to be classified as corporations.

15. Note, however, that we have seen a number of transactions in which departed founders or other former executives brought the deal to a halt because the company needed their votes to approve the excess payments to then-current management. The result — a negotiation with the departed executives and a decision regarding whether to trigger the parachute penalties and "gross up" the recipients or to reach a compromise with the departed executives.

16. An omitted fact is considered material if there is a substantial likelihood that a reasonable shareholder would consider it important.

17. In order for disclosure to be adequate, the company must provide the disclosure to every shareholder entitled to vote.

18. Note that this presumption does not work in reverse — the IRS does not presume that an agreement entered into more than one year before the change in control is safe from being deemed to be contingent on that change in control.

19. Note that in order to take advantage of the shareholder approval exception (discussed earlier), the executive will have to agree to relinquish the right to payment if approval is not received, so it may be very difficult to avoid the "one year" presumption without damaging the ability to rely on the shareholder approval exception.

20. Discussing single or double trigger acceleration of vesting falls outside the scope of this article.

21. Note that the golden parachute rules could apply on an acceleration even if the executive made a section 83(b) election. Section 83(b) of the tax code generally allows a taxpayer to elect to treat property (such as stock) that is subject to a vesting schedule as if it were vested on the day that the property was received. The executive must make the election within 30 days of receiving the property. This allows the executive to be taxed on the value of the property when he or she receives it, rather than on the vesting date, by which time the property may have substantially increased in value. Section 83(b) elections are ignored under the golden parachute rules. Thus, if the vesting of stock accelerates on a change in control, the executive may be subject to the golden parachute rules (using the date-of-vesting value) even if he or she has made a section 83(b) election.

22. It would be a taxable event for options with a "readily ascertainable" fair market value on the date of grant.

23. The regulations contain the following example. "On January 15, 2006, a corporation and a disqualified individual, F, enter into a contract providing for a retention bonus of $500,000 to be paid to F on January 15, 2011. The payment of the bonus will be forfeited by F if F does not remain employed by the corporation for the entire 5-year period. However, the contract provides that the full amount of the payment will be made immediately on a change in ownership or control of the corporation during the 5-year period. On January 15, 2009, a change in ownership or control of the corporation occurs and the full amount of the payment ($500,000) is made

on that date to F. Under these facts, the payment of $500,000 was contingent only on F's performance of services for a specified period and is attributable, in part, to the performance of services before the change in ownership or control. Therefore, only a portion of the payment, . . . is treated as contingent on the change. The portion of the payment that is treated as contingent on the change is the amount by which the amount of the accelerated payment (*i.e.*, $500,000, the amount paid to the individual because of the change in ownership) exceeds the present value of the payment that was expected to have been made absent the acceleration (*i.e.*, $406,838, the present value on January 15, 2009, of a $500,000 payment on January 15, 2011), plus $115,000 (1 percent x 23 months x $500,000) which is the amount reflecting the lapse of the obligation to continue to perform services. Accordingly, the amount of the payment treated as contingent on the change in ownership or control is $208,162, the sum of $93,162 ($500,000 - $406,838) + $115,000). This result does not change if F actually remains employed until the end of the 5-year period."

24. Non-taxable fringe benefits, such as most employer-provided health insurance, are not considered "payments" for this purpose. The rules also exclude amounts contributed to or received from certain "qualified" retirement plans, such as 401(k) plans. ■