Golden Parachute Audit Techniques Guide (02-2005)

NOTE: This guide is current through the publication date. Since changes may have occurred after the publication date that would affect the accuracy of this document, no guarantees are made concerning the technical accuracy after the publication date.

The parachute examination can occur during the examination of either the corporation's or the individual's return. As the examination begins and throughout its course, the following items should be considered :

1. The Code requires that the excise tax payable under § 4999 be administered as an income tax. See § 4999(c)(2). Accordingly, the three-year statute of limitations of § 6501 will apply because, in most cases, there has not been a substantial understatement of income.
2. The outcome of the parachute examination may affect the tax return of a taxpayer (i.e., a current or former employee or independent contractor) in another part of the country so steps should be taken to keep the statute open for the affected taxpayer.
3. Final regulations concerning golden parachute payments were issued on August 4, 2003, and are effective for any payment contingent on a change in ownership or control if the change occurs on or after January 1, 2004. For payments contingent on a change occurring prior to January 1, 2004, taxpayers may rely on the 1989 proposed regulations, 2002 proposed regulations, or the final regulations.
4. The Regulations 1.280G-1 were issued in question and answer format. Any reference to questions and answers (Q/A) in this ATG relate to the final regulations. The key code and regulations for Golden Parachutes are IRC 280G; IRC 4999 and Treas. Reg. 1.280G-1.
5. Potential Adjustments in a Parachute Examination
   - If a payment is determined to be an excess parachute payment the corporation is not allowed a deduction for that payment under § 280G
   - An excise tax of 20% is imposed on the recipient of such a payment under § 4999
   - The payor of the parachute payment must withhold the excise tax if the payment is wages.
6. Golden Parachute Reporting Requirements
   - **Employees:** Generally, golden parachute payments, any taxes withheld, and the total excise tax are reported to employee on Form W-2. The employee must include the 20% excise tax in total taxes on Form 1040.
   - **Non-Employees:** Total golden parachute payments made to non-employees are reported on Form 1099-Misc in Box 7, Non-employee compensation. Any excess parachute payment is reported in box 13, “Excess Golden Parachute Payments”.

Documents to review in a golden parachute examination:

The Board of Director's and Compensation Committee Minutes: Identify activities relating to shareholder approval of mergers, consolidations, or liquidations of the corporation. Also look for discussions of executive compensation due to change in control. The minutes may help identify change in control triggers and payments to be made on a change in ownership or control.

Merger and Acquisition Agreements: These agreements may contain important information in determining if there was a change in control and may contain information about payments that may be made in connection with a change in control. Not all mergers involve a change in control so be alert to the type of merger in which your taxpayer is involved.

The Employment Contracts, Employment Security Agreements and Executive Benefit Plans: The employment agreements and benefit plans may contain additional information about any payments that will be made on a change in control and any change in control triggers.

Deferred Compensation Arrangements: Review the deferred compensation arrangements for payments (including accelerated payments) and/or change in control triggers.

Stock Option and Restricted Stock Plans : These plans may have change in control triggers and may contain additional information about payments that will be made on a change in control (including accelerated vesting or cash out of options).

The 10-K document is the annual report filed with the SEC and provides a complete listing of the Directors a nd executive officers, executive compensation, and the security ownership of certain beneficial owners and management. There is also a description at the back of the 10-K containing additional exhibits filed with the SEC, which may contain additional compensation plans for executives. Generally, these compensation plans are option oriented and discuss vesting of the options, especially if there is a change in control. See www.sec.gov.

The 14A, Proxy Statement Pursuant to Section 14A of the SEC, better known as the Definitive Proxy Statement, is sent to the shareholders of record prior to the Annual Meeting and contains a wealth of information on specific stock options and compensation plans for the executives. It provides details on the types and amount o f compensation provided to the key executives. See www.sec.gov.

Website: Review the parent company's website for information on corporate acquisitions and mergers.

Internet Research: Research internet sources for information on the corporation for the years under audit. Use search engines such as Google.com.

Tax Returns: Review the corporation's Form 1120 and Form 851, Affiliations Schedule, for newly added or omitted subsidiary companies. Analyze M-1 adjustments to determine whether the corporation has reduced its compensation deduction for excess parachute payments. This should appear as a deduction taken for book purposes but not for tax purposes.

Form W-2's and Form 1099's: If a change in ownership or control has occurred, examine the appropriate executive Forms W-2 for large increases in compensation from one year to the next. This should be done for employees of both the target company and the acquiring company. Form 1099 may need to be examined for former executives and/or independent contractors.

Nine Steps to Follow in a Parachute Examination. (Refer to examination steps flow chart)

Step 1: Determine whether there has been a change in ownership or control.

- A change in ownership or control occurs when one person or more than one person acting as a group acquires:
  - 50% or more of the total fair market value or voting power of the corporation (see Q/A-27) or
  - assets with a total gross fair market value equal to or greater than 1/3rd of the total gross fair market value of all of the assets of the corporation. (see Q/A-29, including the exceptions in Q/A-29(b)).
- A presumed change in effective control occurs when:
  - One person or more than one person acting as a group acquires 20% or more of the total voting power of the stock of the corporation, or
  - A majority of the board of directors is replaced during any 12-month period by directors who are not endorsed by a majority of the members of the corporation’s board of directors.

Step 2: Establish who are "disqualified individuals."

- A "disqualified individual" is any individual (or any personal service corporation or similar entity) who is both an employee or an independent contractor and
- A shareholder. This is an individual who owns stock with a fair market value that exceeds 1% of the fair market value of all outstanding stock of the corporation. See Q/A-17.
- An officer. Whether an individual is an officer is based on the facts and circumstances. See Q/A-18.
- A highly compensated individual. This is someone whose annual compensation is $90,000 (adjusted under §414(a)(1)(B)(k)) and who is among a group consisting of the lesser of the highest paid 1% of the corporation or highest 250 employees of the corporation. See Q/A-19.

Step 3: Determine each disqualified individual's "base amount" and multiply it by 3 to establish the "safe harbor amount."

- In general, the base amount is the average annual compensation that was includible in gross income by the disqualified individual, for the individual's most recent five taxable years ending before a cha nge of ownership or control.
- The "safe harbor amount" is the "base amount" times three. If the present value of all the potential parachute payments equals or exceeds this amount, the payments are "parachute payments."
- Look closely at what is included in the base pay. A company could have plans in place that are more sensitive “change in control” triggers then those by statute. The company may treat these early payments as part of the base pay. Check to see if these payments might fall under the “closely associated” standard in the regulations Q/A -22(b). Any payment pursuant to a contract or an amendment to a pre-existing contract entered into within one year before a change of control is presumed to be contingent on the change, unless the taxpayer establishes the contrary by clear and convincing evidence. (IRC 280G(b)(2)(C) and Q/A-25 and 26).

Step 4: Determine what payments in the nature of compensation were made to each disqualified individual that were contingent on the change in ownership or control.

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Only payments in the nature of compensation may be parachute payments. (See IRC §280G(b)(2)(A)). In general, all payments are in the nature of compensation if they arise from an employment relationship or are associated with the performance of services. Wages, bonuses, severance pay, fringe benefits, pension benefits, transfer of property, the accelerated vesting or granting of stock options, and other deferred compensation are characterized as payments in the nature of compensation. Elective or salary reduction contributions to a cafeteria plan, cash or deferred arrangement, or tax-sheltered annuity are also payments in the nature of compensation. (Q/A-11).

- Under IRC 280G, a stock option is treated as property that is transferred at the time it becomes substantially vested. Thus, the vesting of an option is treated as a payment in the nature of compensation. (Q/A-13(a)). For information on the valuation of stock options, see Rev. Proc. 2003-68, 2003-34 I.R.B. 398.
- If golden parachute payments are treated as exempt, review the source of the payments to determine if the exemption requirements are met. See the list of exempt payments in Q/A-5. If these exempt payments are from tax qualified plans then these payments are not subject to the golden parachute tax and do not count toward the three-times-base limit.

Step 5: Determine whether any of the payments that were contingent on the change of ownership or control due to acceleration can have the contingent portion reduced under Q/A-24.

- Generally, a payment is contingent unless it is substantially certain, at the time of the change that it would have been made whether or not the change of control occurred. (Q/A-22(a).) A payment is also treated as contingent on a change if it is contingent on an event that is closely related to a change (e.g., onset of a tender offer or termination of employment), the change actually occurs, and the event is materially related to the change. A material relationship is presumed to exist if the event occurs within one year before or after the change. (Q/A-22(b)).
- Whether or not the disqualified individual is terminated as a result of the change in ownership or control has no bearing on whether the payment is contingent on the change. A payment may be contingent on the change whether the disqualified individual continues employment or is either involuntarily or voluntarily terminated.
- Generally, if a payment is contingent on a change in ownership or control, the full amount of the contingent payment is treated as contingent on the change. However, in certain circumstances only a portion of the payment is treated as contingent (see the next 2 bullets).
- If a payment is vested (without regard to the change) and the change accelerates the time at which the payment is made, Q/A-24(b) applies to determine the portion of the payment that is treated as contingent on the change.
- If a payment becomes vested as a result of the change (assuming that absent the change the payment was contingent only on the continued performance of services for a certain time period and the payment is attributable, in part, to services performed before the date the payment vested), Q/A-24(c) applies to determine the portion of the payment that is treated as contingent on the change. The payout of the remaining salary due under an employment agreement is a severance payment and is not reduced under Q/A-24(c). Instead, the full amount of the payment is treated as contingent on the change. Also, if the payment would vest due to an event other than the performance of services (such as attainment of a performance goal) and the event does not occur prior to the change, neither Q/A-24(b) or (c) applies to reduce the payment. Instead, the full amount of the payment is treated as contingent on the change.

Step 6: Reduce each parachute payment by whatever portion the taxpayer establishes with "clear and convincing evidence" is reasonable compensation for services to be rendered on or after the change of ownership or control. (IRC §280G(b)(4)(A)).

This reduction generally applies when a disqualified individual continues to render services for the corporation after it has experienced a change in control, but the amounts paid for those services are contingent on the change.

- Refraining from the performance of services, such as in compliance with a covenant not to compete, may be considered reasonable compensation for services to the extent it is demonstrated that the agreement substantially constrains the individual's ability to perform services and there is a reasonable likelihood that the agreement will be enforced against the individual. (Q/A-42(b)).

Step 7: Determine the present value of the contingent payment, as reduced by Steps 5 and 6, to determine whether the aggregate present value of all the payments equals or exceeds the "safe harbor amount."

- At this point, the contingent payments are reduced by steps 5 and 6, and the result is merely potential parachute payments. The next step is to determine the present value of all these potential parachute payments. If the aggregate present value is less than the "safe harbor amount," they are not parachute payments. If the aggregate present value equals or exceeds the "safe harbor amount," they are parachute payments.
- The present value of a payment is determined as of the date of the change of ownership or control, or, if the payment is made prior to that date, the date on which the payment is made. (Q/A-31). Present value is generally determined by using a discount rate equal to 120 percent of the applicable Federal Rate (determined under IRC §1274(d)) compounded semiannually. (Q/A-32). This rate is published in the Cumulative Bulletin and in the tax services.

Step 8: If the safe harbor amount of Step 7 is exceeded, determine whether the taxpayer has shown with clear and convincing evidence that a portion of the payment is reasonable compensation for services actually rendered before the change in ownership or control.

- IRC 280G(b)(4)(B) permits the taxpayer to replace the allocable base amount with an amount that represents whatever portion of a parachute payment can be shown with clear and convincing evidence is reasonable compensation for services actually rendered before the change of ownership or control. (Q/A-43)

Step 9: Calculate the "excess parachute payment" by subtracting from each parachute payment the greater of the allocable base amount or the reasonable compensation of Step 8.

- Some companies will gross up payments to cover the excise tax. This gross up amount should also be treated as part of the golden parachute payment.
- Whatever excess parachute payment is attributable to an option is subject to income tax in the year of exercise, excise tax in the year of vesting or grant (if the grant is the event that determines that the payment is contingent), and the deduction is disallowed when the option is exercised.

Golden Parachute Payments Corporate Form 1120 Examination Flowchart