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## HOT TOPICS

### Golden Parachutes

*Excessive payouts related to change-in-control*

Excessive compensation for executives is a practice of which we are never proponents - specifically some of the excessive "golden parachute" payments to executives in change-in-control situations. However, it is important for executives making significant contributions to be rewarded and their companies to be protected during a change-in-control.

Section 4999 of Internal Revenue Code 280(G) was originally established in 1983 to cap change-in-control parachute payments made to executives, or "disqualified individuals." The cap was set at 2.99 x the executive's "base amount." The "base amount" is defined as the executive's past five years average W2 compensation. For executive's whose total change-in-control payment exceeds the 2.99 x "base amount," the company loses the tax deduction and the executive is taxed an additional 20 percent excise tax for the amount that exceeds the "base amount."

While 280(G) was incorporated with good theoretical intention, the practice of 280 (G) is sometimes counterproductive. Often, executives who have been historically under compensated will consequently have a low "base amount" and are penalized by 280(G) for serving in the best interest of the company.

On the other hand, executives who have historically received competitive - or in extreme cases, excessive compensation - create a higher "base amount" that provides coverage for a higher 2.99 x "base amount." Additionally, multi-year, long-term incentive awards, which are typically implemented to motivate outstanding performance and/or make up for a lack of prior awards, are often accelerated and constitute a parachute payment that works against the 2.99 x "base amount."

On Feb. 20, the IRS released proposed regulations which will impact the deductibility of certain "reasonable compensation" items related to parachute payments under 280(G) beginning in January 2004. However, many change-in-control cases reported since Feb. 20 indicate that the IRS is scrutinizing change-in-control payments made to executive officers as if the proposed regulations are already in place.

Longnecker & Associates has identified several potential alternatives to reduce qualified excess parachute payments, subsequent excise tax to executives, and to maintain corporate tax deductions. While these alternatives have been proven over time, the burden of proof lies with the company to provide clear and convincing evidence regarding reasonable compensation.

#### Reasonable compensation *prior* to a change-in-control (CIC)

- under-compensation for prior services rendered
- compensation for replacement fees of investment bankers

#### Reasonable compensation *after* a change-in-control

- compensation for a consulting agreement
- compensation for not performing services under a non-compete agreement

The key, however, is to be proactive (vs. reactive). There is virtually nothing worse "optically" than that of putting a CIC plan in place after the tender offer or after discussions have even begun.

Bottom line: Parachutes are nothing more than executive severance plans. Since 1983, when they were originally legislated into existence, they have become part of the competitive fabric of executive pay. However, to ensure that one is not truly wasting corporate assets, one needs to approach this with ardent caution.