2009: A Turning Point in Change-in-Control Excise Tax Gross-Ups? Do Companies Need to Explore New Strategies?

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[Editor's Note: This article is the first of two articles by the authors addressing Code §280G (golden parachute) issues. The second article will appear in the August issue of the Compensation Planning Journal and will discuss the origins of the excise tax gross-up problems and provide recommendations for a solution to the problems.]

Summary:

The year 2009 may mark a turning point in the controversy over change-in-control excise tax gross-ups. The combination of RMG withhold vote recommendations and the resulting directors' resignations due to a majority of withhold votes will likely cause a decline in the use of excise tax gross-ups. Companies need to explore new strategies for dealing with this change.

INTRODUCTION

A turning point in the contentious issue of excise tax gross-ups may have been reached in 2009. The change-in-control excise tax gross-up has become standard practice at many public companies, but has attracted criticism from activist shareholders and corporate governance advocates for years. The purpose of the excise tax gross-up is to compensate executives for disparate tax treatment between and among executives due to the complicated and somewhat serendipitous mechanics of the change-in-control excise tax imposed under §§280G and 4999 of the Internal Revenue Code of 1986, as amended (the ''Code''). Compensation committees have generally used the excise tax gross-up despite shareholders' dislike for it. Developments in 2009, however, may change the status quo by reducing the use of the excise tax gross-up. RiskMetrics Group (RMG), the organization formerly known as Institutional Shareholder Services (ISS), announced a new policy that will effectively diminish the future use of excise tax gross-ups. This article discusses the RMG policy change and why it will result in a reduction in the use of the excise tax gross-up, and offers suggestions to companies on how to respond to RMG's new policy.

What Changed in 2009?

RMG maintains corporate governance policies that describe how RMG determines whether to recommend a vote ''for,'' ''against'' or ''withhold'' to its clients (generally, institutional shareholders) on various matters presented on company proxies. Among the matters on which RMG advises its clients are the approval of equity compensation plans and the election of the slate of directors proposed by the incumbent board of directors or management. RMG's recommendation on equity compensation plan proposals and the election of compensation committee directors relies, in part, on whether the company under review has ''poor pay practices.''

In 2009, RMG expanded its policy position to provide that poor pay practices include both change-in-control excise tax gross-ups and tax gross-ups on executive perquisites. Before 2009, RMG's policy had been that if a company had poor pay practices RMG would *potentially* recommend a ''withhold'' or ''against'' vote on compensation committee members, the CEO, or potentially the entire board. In addition, RMG would recommend against any equity plan proposed for shareholder approval if the plan was a vehicle for poor pay practices.

Before 2009, RMG listed, among other items, the following as *per se* poor pay practices:

- egregious employment contracts; and
- excessive severance and/or change-in-control provisions (e.g., amounts for which the multiple is in excess of three times pay, the provision of payments without a loss of job function, etc.).

RMG, however, did not list the change-in-control excise tax gross-up as a *per se* poor pay practice.

In 2009, RMG modified its definition of poor pay practices. The modification included excessive severance/change-in-control arrangements, *including any new or materially amended arrangement that provides for the payment of excise tax gross-ups (including modified gross-ups)* and/or a modified single-

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trigger that allows an executive to receive change-in-control severance upon voluntary resignation during a window period following the change-in-control.[1]

RMG confirmed its intention to include all excise tax gross-ups as a poor pay practice in its 2009 Compensation Frequently Asked Questions release (the ''2009 FAQ''). In the 2009 FAQ, RMG provides that if a company adopts a new employment agreement that includes an excise tax gross-up, RMG is likely to issue a ''withhold'' vote recommendation. However, RMG provides that this recommendation will be made based on all the facts and circumstances. A mitigating factor that might prevent a ''withhold'' vote on a particular agreement would be a public commitment by the company not to enter into future employment agreements that provide for excise tax gross-ups.[2]

RMG intends its new policy to preclude new contracts that provide an excise tax gross-up. For example, RMG's new policy applies to newly hired executives and existing executives whom a company promotes to positions that require an employment contract. Similarly, RMG's new policy applies to executives who become participants in severance or change of control plans that contain an excise tax gross-up provision.[3]

RMG's new policy also includes existing arrangements that a company materially modifies that contain an excise tax gross-up. This means that if an executive has an employment agreement in force before 2009, RMG's new policy will apply if the existing (i.e., pre-2009) employment agreement is materially modified. An amendment is material if it requires a company to make a filing with the Securities and Exchange Commission (SEC). An amendment, however, is not material if the company makes the amendment to effect statutory or regulatory changes, such as an amendment to effect changes required by §409A of the Code.

RMG indicates that it may still recommend a ''withhold'' vote against arrangements that contain an excise tax gross-up even if the material amendment is favorable to shareholders (i.e., it eliminates or reduces an executive's rights); however, it appears willing to engage in a weighting process.[4] If the negative amendments or the overall negative impact of the amendment outweighs the positive aspects of the amendment, RMG will recommend a ''withhold'' vote.

RMG's new policy does not prohibit payments subject to the excise tax that result in a loss of the income tax deduction for the company. Instead, the new policy only prohibits the payment of the excise tax itself. The fact the executive may receive compensation that results in the excise tax or loss of the company's deduction will not attract a ''withhold'' vote recommendation from RMG.[5]

THE RESULT OF RMG's POLICY CHANGE

The authors believe that at most public companies where institutional shareholders are influenced by RMG, the threat of a ''withhold'' vote recommendation will be enough to motivate most compensation committee members to stop providing executives with excise tax gross-up protection. At an increasing number of companies, a ''withhold'' vote can result in a director's forced departure from the board. For example, some companies now provide that if a director receives a majority of ''withhold'' votes, the director is obligated to tender his or her resignation, which the full board must review and decide whether to accept. A ''withhold'' vote essentially starts a chain of events that neither the individual director nor the full board would find desirable; thus, it is unlikely that a compensation committee will be willing to risk a director's position for the sake of providing its executives excise tax gross-ups.

SO WHAT IS A COMPANY TO DO? EXCISE TAX MITIGATION TECHNIQUES

RMG's new policy will result in companies and executives approaching change-in-control or severance protection in new ways. The excise tax gross-up was an administratively easy way to address the problem created when the mechanics of the Code's excess parachute payment rules treated similarly situated executives differently, depending on their individual circumstances unrelated to a change-in-control.[6]

There are, however, other techniques that should be considered for mitigating the excise tax. If these techniques are available to the company, they may increase the executive's net payment, reduce the company's out-of-pocket expense, and preserve the company's federal income tax deduction.

[1] *See* RiskMetrics Group, U.S. Corporate Governance Policy, 2009 Updates (Nov. 25, 2008).

[2] 2009 FAQ, Q&A 1.1.

[3] *See* 2009 FAQ, Q&A 1.6 (providing that a new CEO's inclusion into an executive severance plan is regarded as a ''new'' agreement).

[4] *See* 2009 FAQ, Q&A 1.3.

[5] *See* 2009 FAQ, Q&A 1.7.

[6] The excise tax does not always apply consistently between and among executives that are similarly affected by the change-in-control, as their decisions to defer compensation and exercise equity awards prior to the change-in-control can affect whether they must pay an excise tax.

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Each year, public companies must prepare executive compensation disclosures for their proxy information statements. This usually entails an analysis of compensation to be paid in conjunction with certain termination-of-employment scenarios, including a change-in-control termination of employment.

In the future, the process of preparing the proxy information statement should not only include the currently required disclosure information, it should also include an analysis of the amount of the potential excise tax liability owed by executives and an analysis of how executives and the company may mitigate or manage the excise tax through different techniques (some of which are described below).

Limited Cut-Back

A currently used technique is the limited cut-back of change-in-control payments so that the net amount (i.e., the amount actually realized by the executive after the payment of all taxes, including the excise tax) is the greatest. This technique can be illustrated as follows:

Illustration 1 — Typical Excise Tax Calculations

Total parachute payments	$300,000
Base amount	$100,000
Safe harbor	$299,999
Excess parachute payment ($300,000 − $100,000)	$200,000
Excise tax liability ($300,000 − $100,000) × 20%	$40,000

In this illustration, the mechanics of the parachute payment [7] rules provide that the excise tax applies if the total parachute payment (i.e., $300,000) equals or exceeds three times the base amount (i.e., is greater than $299,999). The amount of the excise tax is 20% of the amount of the parachute payments in excess of the base amount (i.e., the ''excess parachute payment'') ($300,000 − $100,000) × 20%).

In the above illustration, a reduction of the parachute payment by $1 eliminates the entire excise tax liability. Without an excise tax gross-up, this cutback benefits both the executive and the company. The executive nets $299,999 of parachute payments before tax withholding (rather than $260,000, with the excise tax), and the company can deduct the entire amount, rather than just the $100,000 base amount.

[7] Under the Code and applicable Treasury regulations, payments contingent upon a change-in-control are called ''parachute payments,'' and the amount subject to excise tax is called an ''excess parachute payment.''

Increase the Value Assigned to Any Restrictive Covenant

Treasury regulations relating to parachute payments provide that compensation in respect of services to be rendered after the change-in-control is not subject to the excise tax. Compensation paid for a restrictive covenant, such as a covenant not to compete is regarded as such compensation (i.e., it is regarded as paid in respect of services to be rendered after the change-in-control).

For example, consider the head of a business unit of a public company. Many such individuals are the senior most contact person of the company for key customers or clients. Business unit heads are usually responsible for driving the business of the company at the unit level, know the details of the relationships between the company and the customers or clients, have been the architects of the unit's business strategy, and could negatively impact the business, both financially and operationally, if they were to leave without a restrictive covenant.

Many companies have designed severance plans, employment contracts and change-in-control agreements that recognize this rule. Some of these companies, however, have only assigned a limited value to the restrictive covenant. One common design is to provide an additional year of severance based upon the executive's agreeing to the restrictive covenant. This typically means the executive will be entitled to one or two years of severance without regard to the restrictive covenant, and if the executive agrees to a restrictive covenant, one additional year of severance.

Following RMG's new policy, it will be incumbent upon companies to approach restrictive covenants with more rigor. Companies will need to retain third-party firms that specialize in valuing restrictive covenants and link these more precisely developed values to the compensation paid to executives upon a change-in-control in connection with a restrictive covenant.

In the authors' opinion, the current approach to restrictive covenants understates the true value of restrictive covenants, which can be significantly greater than one times annual base and bonus.

Provide Damages for Breach of Contract, Rather Than Severance

Treasury regulations provide that if employment is involuntarily terminated before the end of the contract term and the executive is paid damages for breach of contract, those damages may be treated as reasonable compensation for personal services rendered after the change-in-control and, therefore, not subject to the excise tax. A showing of the following factors generally

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is considered clear and convincing evidence that the payment is reasonable compensation for personal services to be rendered after the change-in-control:

- The contract was not entered into, amended or renewed in contemplation of the change-in-control.
- The compensation the executive would have received under the contract would have qualified as reasonable compensation.
- The damages do not exceed the present value (determined as of the date of receipt) of the compensation the individual would have received under the contract if the individual had continued to perform services for the company until the end of the contract term.
- The damages are received because an offer to provide personal services was made by the executive but was rejected by the employer (including involuntary termination or constructive discharge).
- The damages are reduced by mitigation.[8]

The Treasury regulations appear to distinguish between contract damages that, if subject to the factors listed above, are not subject to the excise tax, and severance payments, which are subject to the excise tax.[9] This suggests that the form of the payments needs to be carefully structured, particularly the requirement of mitigation.

In the authors' experience, many arrangements that currently provide for severance payments could be recast instead to provide for damages for breach of contract. However, these arrangements would need to include a mitigation requirement, which many arrangements do not require.

Mitigation would be a reasonable feature to manage total change-in-control expense, reduce the excise tax, and preserve the federal income tax deduction. However, in our experience, most executives do not like a mitigation condition. Most companies would also prefer to avoid it because of the burden of enforcing the mitigation requirement. Nevertheless, due to RMG's new policy, this technique may gain increased favor. Consider the following example:

[8] Treas. Regs. §1.280G-1, Q&A-42.

[9] *See* Treas. Regs. §1.280G-1, Q&A-44.

Illustration 2

Damages for Breach

Damages for Breach	$300,000
Accelerated Vesting of Equity	$200,000
Total	$500,000
Base	$100,000
Total Parachute	$200,000
Payment in Excess of Base	$100,000
Safe Harbor	$299,999
No excise tax	

Severance

Severance	$300,000
Accelerated Vesting of Equity	$200,000
Total	$500,000
Base	$100,000
Total Parachute	$500,000
Payment in Excess of Base	$400,000
Safe Harbor	$299,999
Parachute Payment	$500,000
	−100,000
	$400,000
Excise Tax ($400,000 × 20%)	$80,000

Develop a Case That Change-in-Control Payments Are Reasonable Compensation for Prior Services

Treasury regulations permit payment of reasonable compensation for services rendered prior to a change-in-control to be excluded from the excise tax and loss of deduction consequences. To the extent that there is clear and convincing evidence that some or all of a payment is reasonable compensation for services rendered prior to a change-in-control, related excess parachute payments may be reduced accordingly.[10]

In general, whether payments are reasonable compensation for services rendered is determined based on all the facts and circumstances of the particular case. Factors relevant to such a determination include, but are not limited to, the following:

[10] *See* Treas. Regs. §1.280G-1, Q&A-39.

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- the nature of the services rendered;
- the individual's historic compensation for performing such services; and
- the compensation of individuals performing comparable services in situations in which the compensation is not contingent on a change in ownership or control.[11]

One way to demonstrate that compensation is for services rendered prior to a change-in-control is for the company to record from the annual benchmarking any difference in the individual's actual total direct compensation that is below market competitive pay levels (e.g., the market competitive 50th percentile or the 75th percentile). For example, assume an individual's actual cumulative total direct compensation is $500,000 below the company's desired compensation reference point. The Treasury regulations appear to permit the company to declare that $500,000 worth of the change-in-control payments are for prior services.

Double-Trigger Vesting and Termination of Employment Probability

Compensation that is subject to vesting conditions based on the satisfaction of a service obligation, such as time-based restricted stock or time-based supplemental retirement benefits, is often designed to accelerate vesting upon a change-in-control. This results in a portion of the compensation being treated as a parachute payment.

Governance advocates have suggested that the vesting of such compensation should not be accelerated unless and until the individual experiences a termination of employment following the change-in-control (referred to as a ''double-trigger''). This approach may help reduce the excise tax if the individual is not likely (i.e., less than 50% probability) to be terminated as a result of the change-in-control.

Treasury regulations provide that if a payment (including the value of accelerating the vesting related to such payment) has less than a 50% probability of being paid (or accelerated), it does not have to be included in the parachute payment calculation unless or until the person is actually terminated.[12] This means that an individual who does not experience a termination of employment and whose compensation is subject to the ''double-trigger'' vesting may not have excise taxable compensation.

As discussed below, the use of double-trigger vesting needs to be carefully considered and balanced with the technique of providing for ''early'' vesting in the year before the year of the change-in-control.

Periodic Payments Rather Than a Lump Sum

Another technique for managing the value of the parachute payment is borrowed from the area of structured settlements. In the instance of a structured settlement, a claimant entitled to a certain amount (e.g., $1,500,000) is paid the amount in periodic payments, rather than in a single sum at the outset. This has the effect of reducing the present value of the parachute payment. A single sum payment of $1,500,000 paid in two annual payments of equal amount would be worth approximately $1,464,255 (assuming a 5% discount rate). The two periodic payments reduce the excise tax obligation by approximately $7,000 (20% × $35,000).

Cancellation of Unvested Stock Options That Have Little or No Intrinsic Value

Treasury regulations provide that the vesting of a stock option is treated as the transfer of property or as a payment in the nature of compensation. The value of an option at the time the option vests is determined in accordance with all the facts and circumstances. Rev. Proc. 2003-68 [13] provides guidance on the valuation of stock options solely for purposes of §280G,[14] and directs that options that vest upon a change-in-control should be valued consistently with generally accepted accounting principles (GAAP). Compliance with GAAP means the valuation is to be accomplished based on an option pricing model such as the Black-Scholes model, which takes into account, among other factors, the term of the option on the valuation date. This means that if the stock option has a considerable amount of time remaining before its contractual expiration date, the option may have substantial value for purposes of the excise tax calculation. This may be true even if the stock option is dramatically ''underwater'' (i.e., the excise price is greater than the current value of the underlying stock). Thus, one way to reduce the parachute payment tax value is to automatically cancel or exercise any unvested option upon a change-in-control, thus bringing to an end the term of the option. For an option that is

[11] *See* Treas. Regs. §1.280G-1, Q&A-40.

[12] *See* Treas. Regs. §1.280G-1, Q&A-33.

[13] 2003-34 I.R.B. 398.

[14] Section 3.01 of Rev. Proc. 2003-68 provides that for purposes of §280G, the value of a stock option should not be determined solely by reference to the spread between the exercise price of the option and the value of the stock at the time of the change-in-control.

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underwater, the automatic exercise or cancellation is effectively the end of the option. Thus, the decision to do so may need to be preceded by some analysis to determine what the term is worth, and whether the underlying stock may ultimately achieve the value or a significantly higher value than the value assigned to the stock option.

The same strategy of canceling or causing stock options to be exercised automatically would also have application to options that have positive intrinsic value, and the reduction of the excise tax may compensate the executive for the loss of the value of the option. In order to satisfy governance concerns or to achieve the benefit of the other strategies, including the double-trigger vesting strategy, it may be necessary for the shares received upon exercise to be subject to the balance of the vesting requirements that applied to the stock options.

INADVERTENT CONSEQUENCES OF RMG's POLICY

RMG's new policy, which is likely to result in the decreased use of excise tax gross-ups, may have some unintended consequences. First, some companies may increase the amount of severance provided to executives in the event of a change-in-control. Specifically, an organization that currently provides severance equal to two times base and annual bonus, plus an excise tax gross-up, may drop the excise tax gross-up and increase the amount of the severance to three times base and bonus. The additional amount could be used to offset the excise tax. The amount of the additional severance may or may not be less than the amount of a conventional tax gross-up, so RMG's efforts to reduce costs associated with a change-in-control may be only partially realized.

Another consequence may be an effort by management to negotiate or manage a closing date for the transaction that falls in the next following calendar year. This is because the ''base'' amount of an executive, which is the standard for determining whether parachute payments are so great so as to be subject to the excise tax, is determined on the basis of the taxable compensation for the five-year period ending immediately before the year in which the change-in-control occurs.

For example, a transaction that could close in December 2010 may be delayed until January 2011 in order to permit executives to exercise stock options in December 2010. This would increase the executives' base amount and reduce their exposure to the excise tax. Depending on the non-compensation aspects of a deal, it is possible to manage a closing date from one year into the next year.

A related consequence may be the acceleration of the vesting of restricted stock or stock options into the year immediately preceding the year of the closing date. Governance advocates, like RMG, have been encouraging companies to adopt double-triggers on equity vesting. However, accelerating the vesting of equity, coupled with the exercise of stock options in the year preceding the year of the closing, may also increase the base and reduce the excise tax. It is a bit ironic that RMG's new policy may now work against double-trigger vesting because it benefits shareholders by preserving the company's tax deduction.

Next, Treasury regulations provide that the base amount is increased by the value of restricted property received by the executive and for which the executive makes an election under §83(b) of the Code.[15] Time-based restricted stock is restricted property that is available for a §83(b) election. An executive seeking to mitigate any excise tax liability and expecting a potential change-in-control may opt for a §83(b) election. However, a §83(b) election requires the executive to pay immediate tax on the stock. In addition, if the underlying stock falls in value or is forfeited, the executive cannot recoup any of the taxes paid pursuant to the §83(b) election.

The lack of an excise tax gross-up favors time-based compensation (such as time-based restricted stock or time-based supplemental retirement plans) over performance-based compensation (as noted above, an executive could elect early taxation of time-based restricted stock and increase his or her base amount). In addition, time-based restricted stock counts as a parachute payment only to the extent of one percent of its value for each month of acceleration.[16] Performance-based restricted stock counts fully for each month of acceleration. Comparing a typical 36-month time-based restricted stock award to a 36-month performance share plan that pays at target, the parachute payment amounts (as a percentage of stock value) are as follows:

[15] *See* Treas. Regs. §1.280G-1, Q&A-34.

[16] Treas. Regs. §1.280G-1, Q&A-24(c). The acceleration of time-based restricted stock will also increase the parachute payment value by an amount equal to excess of the value of the stock on the time-based vesting date over the present value on the date of vesting due to the change-in-control. (This amount is not shown.)

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	Time-Based		Performance Base	
Tranche 1	6 months remaining	1% × 6	6 months remaining	16.67%
Tranche 2	18 months remaining	1% × 18	18 months remaining	50.00%
Tranche 3	30 months remaining	1% × 30	30 months remaining	83.33%
	Total:	54%	Total:	150.00%

Finally, the potential for parachute payments may be reduced by shortening the vesting period of equity or other compensation, because shorter vesting periods result in a reduced value caused by the accelerated vesting of compensation upon a change-in-control. Consider the following illustration comparing the accelerated vesting of time-based restricted stock, one instance in which the vesting schedule is 50% over two years, and the other instance in which it is 33% over three years.

	2-Year Vesting (50/50)		3-Year Vesting (33%)	
Tranche 1	1% × 12 months	12%	1% × 12 months	12%
Tranche 2	1% × 24 months	24%	1% × 24 months	24%
Tranche 3	—	—	1% × 36 months	36%
	Total	36%		72%

RMG's new policy will undoubtedly result in companies and executives approaching change-in-control or severance protection in new ways.

This article has explored several alternative techniques that should be considered for mitigating the excise tax. These techniques, if available to a company, may increase the executive's net payment, reduce the company's out-of-pocket expense, and preserve the company's federal income tax deduction.

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