Quantifying Change-in-Control Payments under Proxy Disclosure Rules

More completed and detailed disclosure of executive compensation programs under the SEC's proxy disclosure rules requires that companies report the value of payments in the event of a Change-in-Control (CIC) to Named Executive Officers (NEOs). With very few exceptions, such payments will be covered by the "golden parachute" rules under IRC Section 280G.

This memo discuses some not-so-obvious aspects of calculating these values, including a look at how even a miniscule increase in a CIC payment may, under the highly complex and tax-driven calculations required, end up generating millions of dollars in additional reportable compensation.

Golden Parachutes – An Overview

The golden parachute rules are intended to discourage excessive compensation payments to executives in the event of a CIC by imposing negative tax consequences to both the company and the recipient. Under the rules, if the present value of a CIC payment to an executive exceeds his/her "safe harbor" (that is, three times the executive's average taxable compensation over the five most recent calendar years preceding the CIC, less $1), the company loses tax deductions for the amounts considered "excess parachute payments." Additionally, the executive is required to pay a 20% excise tax on the excess payment. Commonly misunderstood, the penalties resulting from excess parachute payments are calculated based on amounts paid in excess of one times the executive's five year average taxable compensation (base amount), rather than the amount in excess of the safe harbor.

Common CIC Contract Designs

Many employment and CIC contracts require companies to "gross-up" the executive for any excise taxes owed on golden parachutes. These payments are often substantial, given that payment of the gross-up is also subject to income and excise taxes. Alternatively, some executive contracts stipulate that the CIC benefits are cut back if the payments exceed the safe harbor limitations or if the executive is in a better tax position by scaling the payments back to the safe harbor amount.

Implications for Disclosure – An Example

Given the disproportionate impact of even very minor changes in expected CIC payments and the numerous complexities and assumptions involved, calculations must be as accurate as possible. As shown in the illustration below, boosting the calculated value of a CIC payment by as little as $1 would translate into an approximately $4,700,000 increase in the total CIC payments that must be disclosed to shareholders and, under the new rules*, certified by the Chief Executive Officer and the Chief Financial Officer.*

Golden Parachute Rules – A Simplified Example

		CIC Payments in Excess of 280G Safe Harbor with Excise Tax Gross-UP	CIC Payments at 280G Safe Harbor	Diff.
Total CIC Payments	1.	$15,000,000	$14,999,999	$1
Based Amount (Average Compensation over prior 5 years)	2.	$5,000,000	$5,000,000	
Safe Harbor ((2) X 3 less $1)	3.	$14,999,999	$14,999,999	
Are CIC payments in Excess of Safe Harbor?	4.	**YES**	**NO**	
Calculate Excess Parachute Payments ((1) – (2))		$10,000,000	$0	
Executive Excise Taxes @ 20%		$2,000,000	$0	
Excise Tax gross-Up	***A**	$4,667,445	$0	
Total CIC Payments		$19,667,445	$14,999,999	$4,667,446

***A** Based on a 57.15% marginal tax rate (37.15% income and employment taxes, plus the 20% excise tax).

Steps for Calculating the Golden Parachute Payments for NEOs

Companies should take the following steps to accurately calculate the impact of the golden parachute rules on the disclosure of NEO payouts:

- Identify and gather all plans and programs covering NEOs that provide payments or other benefits in the event of a CIC or termination following a CIC.
    - Included would be employment contracts, CIC arrangements, stock plans, annual incentive plans, long-term incentive plans, SERPs, deferred compensation arrangements, severance plans, executive life insurance plans, etc.
- Identify all payments under the contracts that are contingent upon a CIC and, therefore, subject to testing under IRC Section 280G.
    - This often involves numerous grey areas that require judgment.
- Determine each NEO's base amount.
    - For calendar year filers, that includes taxable compensation received from the company for the 2001-2005 tax years.
- Quantify the total CIC payments and determine whether the present value of the CIC payments equals, or exceeds, the safe harbor.
- Calculate the amount of excise taxes, if any, owed by each executive.
- Calculate required gross-up payments for excise taxes and/or expected scale backs.
    - Under most circumstances, the gross-up calculation should consider income, employment, and excise taxes on the payment of the gross-up.

Expect Complexities in the Calculations

While the calculation example shown previously may appear relatively straightforward, there are numerous complexities inherent in most 280G calculations. Moreover, since quantification is driven by tax rules, companies cannot rely on sheer logic to get through the process.

Below are some rules that might not be obvious to a novice:

- The base amount is based on an executive's "taxable" compensation over the five years prior to the date of the consummation of a CIC. It does not include amounts payable to a NEO but that are deferred under a nonqualified deferred compensation plan, a 401(k) plan or Section 125 plan. Nor does the base amount include current year compensation (i.e., payments received in the year that the CIC occurs).
  - Taxable compensation, for calendar year filers calculating CIC payments to be filed in the proxy statement in 2007, should therefore encompass the years 2001-2005, not 2002-2006.
- If an executive did not provide services to the company for the entire five-year period preceding the CIC, compensation is averaged over the executive's service period. Pay to the executive in any short year is annualized, with the exception of one-time payments such as sign-on bonuses.
- Payments made to an executive as a result of a CIC are not always fully included in the test. The CIC value of payments that are made solely due to accelerated vesting or payout can be reduced. The value included in the parachute calculations is the lesser of the CIC payment, or the total of the following two components:
  - *The lapse factor:* The value assigned to the executive's no longer being required to perform services. This is a percentage of the CIC payment equal to 1% times the number of full months between the CIC date and the date that the executive would have otherwise vested in the right to receive the payment.
  - *The present value factor:* The excess of the payment over its discounted present value, which is intended to measure the executive's benefit for receiving the payment earlier than he/she would have absent the CIC.
- Amounts that can be allocated to a non-compete covenant are characterized as reasonable compensation for services rendered after a CIC, and thus are not CIC payments and not included in the calculation.
- CIC payments that are characterized as reasonable compensation for services rendered prior to the CIC reduce the calculated amount of excess parachute payments. However, they are still included in the calculation of whether the CIC payment is in excess of the safe harbor.

HCAS is at the forefront of preparing, private and public companies and their boards for the changes resulting from the final SEC disclosure requirements. Our HCAS services group have over 25 years of in-depth experience consulting on CIC payments and the application of IRC Sections 280G and 4999, as well as the design and structure of CIC plans and programs.

We offer a highly sophisticated 280G calculation model that provides accurate estimates of expected IRC Section 280G excise tax liabilities, no matter how complicated the arrangement.

Please feel free contact us about assisting in the timely development of your new disclosure.