Internal Revenue Service

Golden Parachute Payments Guide

Audit Techniques Guide

Large Business and International

1/20/2017

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 IRC § 4999 be administered as an income tax. See IRC § 4999(c)(2). Accordingly, the three-year statute of limitations of IRC § 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 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 became effective for any payment contingent on a change in ownership or control occurring on or after January 1, 2004.¹

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 Golden Parachute Examination
   - If a payment is determined to be an excess parachute payment, the corporation is not allowed a deduction for that payment under IRC § 280G
   - An excise tax of 20% is imposed on the recipient of such a payment under IRC § 4999
   - The payor of the parachute payment must withhold the excise tax if the payment is wages. The payor of a parachute payment to an independent contractor would not have a withholding requirement.

¹ 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.
6. Golden Parachute Reporting Requirements

- Employees: Generally, wages plus golden parachute payments are reported in box 1, and federal income taxes along with the excise tax are reported in box 2 on Form W-2. The employee must include the 20% excise tax, reported in box 12 with a code K on Form W-2, on the proper line of the other taxes section 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”.

7. Section 162(m) provides that the $1 million limitation should be reduced by any amount of excess parachute payments. For example, if the chief executive officer of a publicly-held company received $2 million dollars from his company in the year it was being acquired, of which $200,000 was excess parachute payments under IRC § 280G, the IRC 162(m) limitation for the CEO would be reduced to $800,000 ($1,000,000 - $200,000). However, this provision for reducing the $1 million limitation for the excess parachute payment may not apply if the executive of the target is not considered a covered employee during the year of an acquisition since the target goes out of existence and his pay is not reported in the proxy statement.

Documents to review in a golden parachute examination:

**Form 10-K** is the annual report filed with the SEC and provides a complete listing of section 16(b) executives and directors, executive compensation, and the security ownership of certain beneficial owners and management (although each of the foregoing may be deferred to the definitive proxy statement or the definitive information statement). Form 10-K provides information for equity compensation plans using a table format setting forth the (a) number of securities to be issued (b) weighted-average exercise price (c) additional shares available for future grants. Any compensation plans adopted in the applicable year without stockholder approval are provided as an exhibit. Also, Form 10-K frequently references additional compensation plans that were previously filed with the SEC. These compensation plans frequently include stock options, restricted stock, and other types of equity-based compensation for executives. Form 10-K may discuss the vesting provisions of such equity-based compensation especially in the event of a change in control.

SEC filings can be downloaded from the [SEC website](https://www.sec.gov).

**DEF 14A, Proxy Statement Pursuant to Section 14A of the SEC**, better known as the Definitive Proxy Statement, or the annual proxy statement, is the easiest place to look up information on executive compensation. This proxy statement is sent to the shareholders of record prior to the Annual Meeting and may contain information about specific stock options and compensation plans for executives. It is more detailed than Form 10-K and provides specific detail as to the number of options granted and the total exercise price under the various plans.
Schedule 14A, Information Statement Pursuant to Section 14(a) of the SEC and Schedule 14C, Information Statement pursuant to Section 14(c) of the SEC disclose information regarding golden parachute payments in connection with the solicitation for shareholders’ approval as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act. The provision requires a shareholder advisory vote, commonly referred to as “vote on golden parachute payments” for any new executive compensation arrangements in connection with a merger, acquisition, consolidation, proposed sale, or disposition of all or substantially all assets of a public company. The company is required to disclose all parachute payments that may be made if a change in control occurs. A “Golden Parachute Compensation” table that shows quantitative information about the components of the parachute payments based the per share price is required. Narrative descriptions for the triggers, conditions for payment, how payments are made, who makes payments, and how long the payments are made are required in the table. Additionally, any parachute payments actually made upon a change in control must be reported. Companies were required to comply with these golden parachute shareholder advisory vote and disclosure requirements on proxy statements and consent solicitations filed seeking shareholder approval of a transaction after April 25, 2011. The rules of the Dodd-Frank Act require the disclosure of golden parachute payments in proxy statements and informational statements filed on Schedule 14A as well as Schedule 14C. SEC filings can be downloaded from the SEC website.

Forms S-4 and F-4, often referred to as the Registration Statement under the Securities Act of 1933, are used to provide information to investors when registering securities. They provide information related to mergers, acquisitions, or when securities are exchanged between companies. Form F-4 is specifically used to register securities offered by foreign issuers.

SEC filings can be downloaded from the SEC website.

The Board of Directors 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 infor-
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).

**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 Schedule M- 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, review the appropriate executives’ 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 Perform 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 in a 12-month period. (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 in a 12-month period, 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. (See Q/A-28).

**Step 2: Determine the "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, officer, or highly compensation individual.

- 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 above $120,000 for 2015, 2016 or 2017 (adjusted under IRC § 414(q)(1)(B)(i) and indexed annually under IRS announcement published in the fall for pension plan limitations) 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). A search of irs.gov using the term “IRC § 414(q)(1)(B) limitations” will locate the announcement.

**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 change 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 have 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. (See (Q/A-22(b)). Any payment pursuant to a contract (or a portion of a payment pursuant to 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. (See 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.

- 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. (See 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. (See 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. Q/A-5 has a list of exempt payments. 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. (See 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. (See 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 specified 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. (See 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. (See 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. (See Q/A-31). Present value is generally determined by using a discount rate equal to 120 percent of the Applicable Federal Rate (AFR) determined under IRC §1274(d) compounded semiannually. (See Q/A-32). This AFR 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. (See Q/A-39 and 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 Flow Chart - This chart provides assistance in determining whether IRC § 280G is applicable to a public corporation. The chart does not consider whether a private corporation has met an exemption from IRC § 280G. This chart and the ATG should never be used without consulting the Code and the Regulations.1 2

Start

Step 1 – Determine if there has been a change in control of a public corporation?
IRC §280G(b)(2)(A)(i)(I) or (II)

No

Yes

Determine if private corporation meets one of the exemptions from IRC §280G.

Step 2 – Identify the “disqualified individuals” and the potential parachute payments.
IRC §280G(b)(2) and §280G(c)

Step 3 – Determine the "Safe Harbor Amounts" for each disqualified individual.
IRC §280G(b)(2)(A)(ii)

Discontinue Exam

No

Yes

Step 4 – Were the potential parachute payments contingent on the change in ownership or control?
IRC §280G(b)(2)(A)(i)

No

Yes

Step 5 – Can any accelerated payments be reduced under Q/A – 24?

Yes

No

Step 6 – Does any portion of the payment represent post-change reasonable compensation?
IRC §280G(b)(4)(A)

Yes

No

Step 7 – Have disqualified individuals “Safe Harbor Amounts” been exceeded?  IRC §280G(b)(2)(A)(ii)

No

Yes

Step 8 – Is a portion of any “excess parachute payment” pre-change reasonable compensation that exceeds the base amount allocated to the payment?
IRC §280G(b)(4)(B)

Yes

No

Step 9A – The nondeductible "excess parachute payment" is the difference between the payment and the reasonable compensation. IRC §§280G(b)(1) and 280G(b)(4)(B)

No

Step 9B – The nondeductible "excess parachute payment" is the difference between this payment and its allocable base amount. IRC §280G(b)(1)

1 S Corporation Exception - IRC § 280G(b)(5)(A)(i) and Treas. Reg. § 1.280G-1 Q/A 6 provides that a parachute payment does not include any payment from a corporation that could have qualified as an S corporation under IRC § 1361(b).

2 Shareholder Approval Exception – If 75% of the disinterested shareholders of certain corporations approve the parachute payments and received all of the material facts of the payments prior to the vote, then the shareholder approval exception requirement is met. IRC § 280G(b)(5)(A)(ii) and (B) and Treas. Regs. §1.280G-1 Q/A 7