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Golden Parachute Payments under Proposed Treasury Regulation Section 1.280G-1: Analysis and Recommended Changes

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GOLDEN PARACHUTE PAYMENTS UNDER PROPOSED TREASURY REGULATION SECTION 1.280G-1: ANALYSIS AND RECOMMENDED CHANGES

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I. INTRODUCTION

Proposed Treasury Regulation section 1.280G-1[1] represents a major step in providing guidance to a complex and controversial area of tax law. This proposed regulation, however, is not without its shortcomings. The regulation does not clarify some important ambiguities, does not provide enough examples based on common recurring fact patterns, and may cause different tax results for similarly situated taxpayers. This Article will analyze the proposed regulation governing golden parachutes as well as the comments submitted to the Internal Revenue Service by tax attorneys, accountants, and other tax professionals regarding the impact of certain sections of the proposed regulation.

Part II of this Article presents a brief history of section 280G, including the tax treatment of golden parachute payments before 1984, the original version of section 280G, and the subsequent revisions made by Congress. Part III is an overview of Proposed

1. Prop. Treas. Reg. § 1.280G-1, 54 Fed. Reg. 19,390 (1989).

Treasury Regulation section 1.280G-1 and discusses the various components of the proposed regulation with special emphasis on the comments by tax professionals.

II. A BRIEF HISTORY OF GOLDEN PARACHUTES

Golden parachutes are special employment agreements designed to protect top executives in the event of a corporate takeover.[2] The protection is provided in the form of an unusually lucrative compensation package for top executives if there is a change in control of their corporation.[3] Most parachute agreements do not actually furnish the extraordinary shelter until the executives either voluntarily or involuntarily terminate their relationship with the corporation. Golden parachutes have been defended[4] and attacked[5] with great vigor by

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2. For a detailed discussion of various types of golden parachute agreements, *see generally* WARD HOWELL INTERNATIONAL, INC., SURVEY OF EMPLOYMENT CONTROLS AND "GOLDEN PARACHUTES" AMONG THE FORTUNE 1000 (1983) (analyzing a survey of 665 Fortune 1000 companies); Riger, *On Golden Parachutes—Ripcords or Ripoffs? Some Comments on Special Termination Agreements*, 3 PACE L. REV. 15 (1982) (examining the validity of golden parachute agreements); Comment, *Future Executive Bailouts: Will Golden Parachutes Fill the American Skies?*, 14 TEX. TECH L. REV. 615 (1983) (discussing the impact of golden parachute agreements on the corporation, its officers, and its shareholders).
3. The compensation packages may include guaranteed annual salaries, bonuses, lifting of stock option restrictions, early or automatic vesting of retirement plans, and continuation of coverage under medical plans. *See* Comment, *Golden Parachutes and Draconian Measures Aimed at Control: Is Internal Revenue Code Section 280G the Proper Regulatory Mode of Shareholder Protection?* 54 U. CIN. L. REV. 1293 (1986) [hereinafter Comment, *Draconian Measures*] (concluding that state corporate law is a proper method of protecting shareholders); Hood & Benge, *Tax Cost of Protecting Executives when Corporate Ownership Changes has Increased*, 36 TAX'N FOR ACCTS. 92 (1986) (analyzing the proper tax planning to reduce costs of golden parachute payments to the corporation and executive).
4. Proponents of golden parachutes have advanced three main arguments in support of their position: (1) golden parachutes act as a deterrent to corporate takeovers by increasing costs; (2) they benefit the corporation by attracting and retaining top executives; and (3) they stimulate objective decision making during takeover bids by reducing top executive fears about employment if a takeover is successful. *See generally* Krueger, *Opportunities and Pitfalls in Designing Executive Compensation: The Effects of the Golden Parachute Tax Penalties*, 63 TAXES—THE TAX MAGAZINE 846 (1985); Note, *Golden Parachutes and the Business Judgment Rule: Toward a Proper Standard of Review*, 94 YALE L.J. 909 (1985) [hereinafter Note, *Proper Standard of Review*]; Johnson, *Government Regulation of Business: Golden Parachutes Revisited*, 23 WAKE FOREST L. REV. 121 (1988).
5. Johnson, *supra* note 4, at 125-26. Opponents of golden parachutes have attempted to refute the main elements of the defender's position by arguing:
   (1) that parachute payments are insignificant when compared to other

surveyors of the corporate landscape.[6]

A. Golden Parachutes Prior to 1984

Prior to the Deficit Reduction Act of 1984 (1984 Act),[7] the tax treatment of golden parachute payments was determined solely by section 162(a)(1) of the Internal Revenue Code.[8] Under section 162(a)(1), a corporation was allowed to deduct all ordinary and necessary business expenses, including a reasonable allowance for services actually performed. Compensation had to be both reasonable and purely for services in order to be deductible by the corporation.[9] The determination of reasonableness, however, was not an easy task and created questions of fact to be decided on a case-by-case basis.[10] Courts considered factors such as (1) employee's qualifications, (2) amount and nature of employee's work, (3) current economic conditions, and (4) compensation received by similar employees at similarly situated corporations.[11] The issue of whether amounts were deductible was most often encountered in cases involving closely held corporations. In such cases, courts analyzed amounts received as salaries, dividends, and rent or payment for property. For example, if the salary of an employee was greater than that which would have been paid for similar services, and the larger payments corresponded to the employee's stockholdings, part of the employee's salary was considered a dividend, and therefore, nondeductible.[12]

B. Golden Parachutes Since 1984

Since the 1984 Act, tax treatment of golden parachute agreements has generally been governed by sections 280G and 4999 of the Internal Revenue Code. Parachute payments that pass the rules of section 280G, however, must also comply with the underlying section 162

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takeover costs and therefore do not deter takeovers; (2) top executives are already well compensated, thus parachute payments are an unreasonable waste of corporate assets and (3) top executives have a fiduciary duty to act in the best interests of corporate shareholders. *Id.*

6. The scope of this Article is not intended to cover a detailed analysis of nontax law approaches to golden parachutes. For an excellent discussion of a nontax law approach, see Note, *Proper Standard of Review*, *supra* note 4, at 909-28.
7. Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984).
8. I.R.C. § 162(a)(1) (West Supp. 1991).
9. *See* Treas. Reg. § 1.162-7(a) (1960).
10. *See, e.g.*, Miller Mfg. Co. v. Comm'r., 149 F.2d 421, 423 (4th Cir. 1945).
11. *See, e.g.*, Mayson Mfg. Co. v. Comm'r., 178 F.2d 115, 119 (6th Cir. 1949); Schneider & Co. v. Comm'r., 500 F.2d 148, 152 (8th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975).
12. *See* Treas. Reg. § 1.162-7(b)(1) (1960).

standard of "reasonable compensation" in order to be deductible by a corporation. Thus, post-1984 Act golden parachute agreements are governed by all three code sections. Section 280G was originally enacted in 1984 and has been modified by Congress in 1986 and 1988.

C. *Original Version of Section 280G*

Congress, in the 1984 Act, added restrictive rules based on concerns that golden parachutes might: (1) impede corporate acquisition activity, (2) motivate top executives involved in a proposed takeover to favor a deal that was not in the best interest of shareholders, and (3) reduce amounts which could otherwise be paid to shareholders.[13] As originally enacted, the golden parachute rules denied any deduction under section 162 for compensation on any "excess parachute payment"[14] and subjected the recipient to a nondeductible twenty percent excise tax for such payment.[15] Furthermore, withholding was required on both regular income tax and the penalty excise tax generated by parachute payments.[16]

A "parachute payment" is defined as any payment to a disqualified individual which was in the nature of compensation, if the payment: (1) is contingent on a change in corporate ownership, effective control, or ownership of a substantial portion of corporate assets, and (2) the total present value of such payments equals or exceeds three times the base amount.[17] Present value is determined under section 1274(b)(2).[18] Also, parachute payment includes any payment to a disqualified individual in the nature of compensation that violates any securities law or regulation.[19]

A "disqualified individual" is defined by the statute as any individual who is: (1) an employee, independent contractor, or other person specified by the Department of the Treasury in regulations who performs personal services for the corporation, and (2) is an officer, shareholder, or highly compensated individual.[20] There is a

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13. *See* JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, 98th Cong., 2d Sess., 199-200 (Jt. Comm. Print 1984).
14. I.R.C. § 280G(a) (West Supp. 1991).
15. *Id.* §§ 275(a)(6), 4999(a).
16. *Id.* § 3121(v)(2)(A).
17. *Id.* § 280G(b)(2)(A).
18. *See id.* § 280G(d)(4). Section 280G(d)(4) provides: "Present value shall be determined by using a discount rate equal to 120 percent of the applicable Federal rate (determined under section 1274(d)), compounded semiannually." *Id.*
19. *Id.* § 280G(b)(2)(B).
20. *Id.* § 280G(c).

presumption that any payment made under an agreement which is either entered into or amended within one year of the change of control or ownership is a parachute payment, unless there is evidence to the contrary.[21]

Section 280G(b)(1) provides that an "excess parachute payment" is the "amount equal to the excess of any parachute payment over the portion of the base amount allocated to such payment."[22] The term "base amount" is an individual's annualized includible compensation for a base period.[23] The base period consists of the five most recent taxable years prior to a change in ownership or control, or the portion of this period during which the individual is an employee of the corporation.[24] During the base period, "annualized includible compensation" is the average annual compensation which is payable by the corporation and includible by the disqualified individual as gross income.[25] If the individual performs personal services and establishes by clear and convincing evidence that any part of the parachute payment is reasonable compensation, the "excess parachute payment" is reduced by the reasonable compensation portion of the parachute payment.[26]

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21. *Id.* § 280G(b)(2)(C).
22. *Id.* § 280G(b)(1).
23. *Id.* § 280G(b)(3)(A).
24. I.R.C. § 280G(d)(2) (Supp. III 1985). The phrase "was an employee of the corporation" was changed to "performed personal services for the corporation" under the 1986 amendments. *See* I.R.C. § 280G(d)(2) (West Supp. 1991).
25. *Id.* § 280G(d)(1).
26. I.R.C. § 280G(b)(4) (Supp. III 1985). Section 280G(b)(4) originally read as follows:

> In the case of any parachute payment described in paragraph (2)(A), the amount of any excess parachute payment shall be reduced by the portion of such payment which the taxpayer established by clear and convincing evidence is reasonable compensation for personal services actually rendered. For purposes of the preceding sentence, reasonable compensation shall be first offset against the base amount.

Section 280G(b)(4) was amended in 1986 to read:

> In the case of any payment described in paragraph (2)(A)—
>
> (A) the amount treated as a parachute payment shall not include the portion of such payment which the taxpayer established by clear and convincing evidence is reasonable compensation for personal services to be rendered on or after the date of the change described in paragraph (2)(A)(i), and
>
> (B) the amount treated as an excess parachute payment shall be reduced by the portion of such payment which the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered before the date of the change described in paragraph (2)(A)(i).
>
> For purposes of subparagraph (B), reasonable compensation for services actually rendered before the date of the change in paragraph (2)(A)(i) shall be first offset against the base amount.

I.R.C. § 280G(4) (West Supp. 1990).

These golden parachute rules were designed to limit parachute payments, and therefore, should have dissuaded the creation of post-1984 Act golden parachute agreements. Nevertheless, a number of methods were devised to circumvent Congress' intended purpose. For example, increasing the employee's base amount, and cash bonuses in certain circumstances, avoided the golden parachute provisions. Commentators immediately noted problems with the original version of section 280G such as: (1) key points of the provision were unnecessarily vague (for example, change of control was not defined), (2) traditional compensation agreements that did not possess the evil purposes Congress sought to remedy were being penalized, and (3) parachute agreements between closely held corporations and employees were needlessly being penalized.[27]

D. The 1986 Amendments

The Tax Reform Act of 1986 (the 1986 Act) added exemptions to the golden parachute rules and significantly modified the treatment of reasonable compensation.[28] The first modification reduced the likelihood that the golden parachute rules would apply to parachute agreements between a closely held corporation and a person who performed personal services for such a corporation. This was accomplished by the addition of section 280G(b)(5) which provides that any payments made by certain closely held corporations to disqualified individuals are exempted from "parachute payment" classification.[29] Section 280G(b)(5) also provides an exemption from "parachute payment" status for payments made by a corporation, if the corporation has no readily tradeable stock, and the shareholders, by a vote of more than seventy-five percent, approve of the payments after adequate disclosure.[30]

The 1986 Act also added section 280G(b)(4)(A) which states that the term "parachute payment" does not include any part of a payment which the taxpayer can demonstrate by clear and convincing evidence is reasonable compensation for the performance of services on or after a change in ownership or control.[31] Also, a payment to or from a qualified plan, annuity plan, or simplified employee

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27. *See, e.g.*, J. EUSTICE, THE TAX REFORM ACT OF 1984: A SELECTIVE ANALYSIS 3-52 to 3-55 (1984); Report of the Comm. on "Golden Parachutes," N.Y. State Bar Assn. Tax Section, *The "Golden Parachute" Provisions of TRA '84*, 27 TAX NOTES 949 (1985) (commenting on interpretative issues under the golden parachute provisions).
28. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 1804(j), 100 Stat. 2085, 2087 (1986) (codified as I.R.C. § 280G (West Supp. 1987)).
29. I.R.C. § 280G(b)(5)(A)(i) (West Supp. 1991).
30. *Id.* §§ 280G(b)(5)(A)(ii), (b)(5)(B).
31. *Id.* § 280G(b)(4)(A); *see also supra* note 26.

pension is excluded from "parachute payment" classification.[32] There were additional modifications to golden parachute rules involving affiliated groups,[33] highly compensated individuals,[34] and securities laws violations.[35] The changes to the 1986 Act did address some of the earlier criticisms by adding a definition of "highly compensated individual" and excluding certain payments from the golden parachute rules. However, a number of criticisms were not dealt with, but rather were left for future regulations.

E. The 1988 Revisions

The Technical and Miscellaneous Revenue Act of 1988 (the 1988 Act)[36] made additional revisions to the golden parachute statutes in order to clarify some minor items. In the 1988 Act, Congress made it so a corporation could qualify for the shareholder approval exemption, even if the corporation had nonvoting preferred stock which was publicly traded.[37] The legislative history demonstrates Congress' belief that in some situations preferred stock is "more in the nature of debt than equity" and suggests that the intent of golden parachute provisions was to protect those "shareholders whose interest in the corporation could be impaired by parachute payments to disqualified individuals."[38] However, nonvoting preferred shareholders do not need this protection if they "receive the redemption or liquidation value to which they are entitled."[39] Congress eliminated this problem

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32. I.R.C. § 280G(b)(6) (West Supp. 1991).
33. *Id.* § 280G(d)(5).
34. *Id.* § 280G(c). The 1986 Act amendments added the following language to section 280G(c): "For purposes of paragraph (2), the term 'highly compensated individual' only includes an individual who is (or would be if the individual were an employee) a member of the group consisting of the highest paid 1 percent of the employees of the corporation or, if less, the highest paid 250 employees of the corporation." *Id.*
35. *Id.* § 280G(b)(2)(B). The 1986 Act amendments added the following language to section 280G(b)(2)(B):

> In any proceeding involving the issue of whether any payment made to a disqualified individual is a parachute payment on account of a violation of any generally enforced securities laws or regulations, the burden of proof with respect to establishing the occurrence of a violation of such a law shall be upon the Secretary.

Id.
36. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1018(d)(6), 102 Stat. 3342, 3581 (1988).
37. I.R.C. § 280G(b)(5)(A)(ii)(II) (West Supp. 1991). The following language was added to this section in 1988: "Stock described in section 1504(a)(4) shall not be taken into account under clause (ii)(I) if the payment does not adversely affect the shareholder's redemption and liquidation rights." *Id.*
38. S. REP. No. 445, 100th Cong., 2d Sess. 394, *reprinted in* 1988 U.S. CODE CONG. & ADMIN. NEWS 4515, 4905.
39. *Id.*

by amending section 280G(b)(5) so that, for purposes of the shareholder approval requirements, the term "stock" would not include any stock that was nonvoting, nonconvertible, limited, and preferred as to dividends, redemption, and liquidation rights limited to its issue.[40] Thus, corporations with such stock can qualify under the shareholder approval exemption.

The Secretary of the Treasury's regulatory authority was expanded by the 1988 Act to deal with issues concerning the application of shareholder approval requirements for a corporation with no publicly traded stock.[41] It was anticipated that the regulations would address the application of shareholder approval requirements in the case of entity shareholders and where an entity owned a de minimis amount of stock.[42]

Prior to the 1988 Act, section 280G(b)(5) prohibited small business corporations having nonresident alien shareholders from qualifying under the small business corporation exemption provision. The 1988 Act deleted this prohibition by enlarging the small business corporation exemption to include corporations with foreign shareholders.[43] The rationale for this change was that the original version discriminated against foreign persons and would have violated certain United States treaties.[44] Although the 1986 and 1988 changes in section 280G eliminated some of the problems and inequities, a number of problems remained unresolved and were left for the Secretary of the Treasury to address through regulations.

III. AN OVERVIEW OF PROPOSED REGULATION SECTION 1.280G-1

A. Parachute Payment

Q/A-1 of Proposed Treasury Regulation section 1.280G-1 states that "[s]ection 280G disallows a deduction for any 'excess parachute

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40. *See* I.R.C. §§ 280G(b)(5)(A)(ii)(II), 1504(a)(4) (West Supp. 1991).
41. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1018(d)(7), 102 Stat. 3342, 3581 (1988) (codified as I.R.C. § 280G(b)(5) (West Supp. 1991)). The following language was added to section 280G(b)(5):
> The regulations prescribed under subsection (e) shall include regulations providing for the application of this subparagraph in the case of shareholders which are not individuals (including the treatment of nonvoting interests in an entity which is a shareholder) and where an entity holds a de minimis amount of stock in the corporation.

Id.
42. *See id.*
43. I.R.C. § 280G(b)(5)(A)(i) (West Supp. 1991). The phrase "but without regard to paragraph (1)(c) thereof" was added to section 280G(b)(5)(A)(i) under the 1988 Act. The effect of this addition was to permit small business corporations with foreign shareholders to qualify under the exemption. *See id.* § 1361(b)(1)(C).
44. S. REP. No. 445, 100th Cong., 2d Sess. 394, *reprinted in* 1988 U.S. CODE CONG. & ADMIN. NEWS 4515, 4905.

payment' paid or accrued."[45] Q/A-2(a) defines a "parachute payment" as any payment which meets each of the following requirements: (1) the payment is in the nature of compensation; (2) the payment is made to, or for the benefit of, a disqualified individual; (3) the payment is contingent on a change in ownership or control; and (4) the payment has an aggregate present value of at least three times the individual's base amount.[46] In addition, a parachute payment includes any payment in the nature of compensation to, or for the benefit of, a disqualified individual, pursuant to an agreement which violates a securities law or regulation.[47]

B. Payor of Parachute Payments

The payor of parachute payments is not necessarily the corporation facing a change in ownership or control, but also may be a person acquiring ownership or control of that corporation.[48] Moreover, the attribution rules of section 318(a)[49] may be implicated to create constructive payors of parachute payments.[50] Therefore, the proposed regulation prevents the avoidance of golden parachute rules by simply having a section 318(a)-related person make the payment.

C. Payments in the Nature of Compensation

1. The Nature of Compensation

The first requirement for classifying a payment as a parachute payment is that it must be "in the nature of compensation."[51] The term "in the nature of compensation" is not, however, precisely defined by statute or legislative history. This omission concerns commentators because it can presumably result in applications of section 280G to situations not intended by Congress.[52] The proposed regulation provides that "all payments—in whatever form—are payments in the nature of compensation if they arise out of an employment relationship or are associated with the performance of services."[53]

Wages and salary, bonuses, severance pay, fringe benefits, pension benefits, and other deferred compensation arrangements are

45. Prop. Treas. Reg. § 1.280G-1, Q/A-1, 54 Fed. Reg. 19,390, 19,393 (1989).
46. *Id.* § 1.280G-1, Q/A-2(a), 54 Fed. Reg. at 19,394.
47. *See id.* § 1.280G-1, Q/A-2(b), 54 Fed. Reg. at 19,394.
48. *See id.* § 1.280G-1, Q/A-10, 54 Fed. Reg. at 19,395.
49. *See* I.R.C. § 318(a) (West Supp. 1991).
50. *See* Prop. Treas. Reg. § 1.280G-1, Q/A-10, 54 Fed. Reg. at 19,395-96.
51. *See* I.R.C. § 280G(b)(2)(A) (West Supp. 1991).
52. *See, e.g.*, Comment, *Draconian Measures*, *supra* note 3, at 1304.
53. Prop. Treas. Reg. § 1.280G-1, Q/A-11(a), 54 Fed. Reg. at 19,396.

examples of such compensation. Compensation is not limited, however, to these items.[54] Moreover, since there is no specific condition that the payments must be includible in gross income, these payments could be current or deferred. Free use of corporate assets by an independent contractor performing services for the corporation would be a payment in the nature of compensation. In addition, performance of services would include an individual who refrains from performing services under a covenant not to compete or similar arrangement.[55]

Attorney's fees or court costs incurred in connection with a payment in the nature of compensation to a disqualified individual in a change in ownership or control situation is not a payment in the nature of compensation.[56] Therefore, if an executive pursues a legal remedy to enforce a parachute agreement and the agreement provides for payment of attorney's fees and court costs, the payment is not deemed in the nature of compensation.

2. Property Transfers

A transfer of property is treated as a payment in the nature of compensation[57] and taken into account at its fair market value.[58] The proposed regulation provides that a transfer of property is a payment made or to be made in the taxable year in which the property transferred is includible in the gross income of the disqualified individual under section 83.[59] Therefore, generally a parachute payment is made when the property is transferred to a disqualified individual and becomes substantially vested in that individual.[60] A transfer of property occurs under section 83 when a person acquires a beneficial ownership interest in the property.[61] Property is substantially vested when it is either transferable or not subject to a substantial risk of forfeiture.[62] Generally, property rights are considered transferable only if the rights in property in the hands of the transferee are not subject to a substantial risk of forfeiture.[63] A substantial risk of forfeiture is not defined by the code or regulations, however, section 83(c)(1) provides that the rights of a person in

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54. *Id.*
55. *See id.*
56. *See id.*
57. *See* I.R.C. § 280G(d)(3) (West Supp. 1991).
58. *See id.*; *see also* Prop. Treas. Reg. § 1.280G-1, Q/A-12(a), 54 Fed. Reg. at 19,396.
59. Prop. Treas. Reg. § 1-280G, Q/A-12(a), 54 Fed. Reg. at 19,396.
60. *Id.*
61. *See* Treas. Reg. § 1.83-3(a) (1985).
62. *See id.* § 1.83-3(b).
63. *See id.* § 1.83-3(d).

property are subject to a substantial risk of forfeiture if the person's right to full enjoyment of the property is conditioned upon the future performance of substantial services.[64] The regulations provide illustrations of what may be considered substantial or insubstantial risks of forfeiture.[65]

Section 83(b) offers the taxpayer the option to include in gross income the property transferred in connection with the performance of services in the year of transfer, even if the property is not substantially vested at the time of transfer.[66] The proposed regulation, however, disregards the section 83(b) election and provides that the payment is generally deemed to be made when the property is transferred and becomes substantially vested.[67]

This proposed regulation has been criticized for requiring both transfer and vesting of property before a payment in the nature of compensation is made. Some commentators have argued that Q/A-12 of the proposed regulation "misinterprets the legislative intent and also incorrectly applies the rules of section 83 concerning when a transfer occurs."[68] This position is supported by examples which illustrate how pinpointing on vesting may lead to results which Congress could not have intended.[69] These commentators make a

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64. I.R.C. § 83(c)(1) (West Supp. 1991); *see also* Treas. Reg. § 1.83-3(c)(1) (1985).
65. *See* Treas. Reg. § 1.83-3(c)(2). For example, a condition that the employee must return the property to the employer if the employee leaves his job within five years is a substantial risk of forfeiture, while a condition that the property must be returned if the employee violates a covenant not to compete ordinarily is not considered a substantial risk of forfeiture.
66. *See* I.R.C. § 83(b) (West Supp. 1991).
67. Prop. Treas. Reg. § 1.280G-1, Q/A-12(b), 54 Fed. Reg. at 19,396. "An election made by a disqualified individual under section 83(b) with respect to transferred property will not apply for purposes of this A-12." *Id.*
68. Lewis & Fuchs, *Lewis and Fuchs Recommend Changes in Golden Parachute Rules Affecting Nonvested Stock*, 44 TAX NOTES 269 (1989).
69. *See id.* at 269. Lewis and Fuchs stated in part:

> Under the terms of a nonqualified, stockholder approved, stock bonus plan of a large, publicly-traded company, title to company stock is periodically transferred to participating executives in their own names. The shares are regularly awarded under the plan in the ordinary course of ordinary company business and in amounts that establish a recognizable pattern during the many years (which predate the effective date of the golden parachute rules) in which the plan has been in operation. The transfer of stock under the plan includes both dividend and voting rights with respect to the transferred shares which are considered issued and outstanding for all corporate, SEC and New York Stock Exchange purposes. The plan contains a vesting schedule which requires forfeiture of any nonvested shares if the participant fails to continue in service for the required period.
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> . . . .
>
> If the vesting of shares granted under the plan described above is

sound argument that the payment occurs when a beneficial interest is transferred by noting the apparent distinction in section 83 between "transfer" and "ownership."[70] The amount of the payment is also determined under section 83, and generally it is equal to the excess of the fair market value of the transferred property when the property becomes substantially vested over the amount paid for the property.[71]

> viewed as a payment for purposes of section 280G, then, shares awarded in year one, which become vested in year five, by operation of the terms of the plan, may be viewed as parachute payments if there should happen to be a change in ownership or control in year five. Assuming that the shares were not awarded or transferred in contemplation of a change in ownership or control, it seems unlikely that Congress intended to treat such vesting as a parachute payment. The benefit received by the participant as a result of this vesting seems entirely distinguishable from "one-shot" payments made to corporate executives at the time of the change in ownership or control which are made in conscious contemplation of a change in ownership or control.

Id.

70. *See id.* A section 83 transfer "involves the conveyance of a certain quantum of beneficial interest from the employer to the employee, but this transfer does not ripen into full ownership for tax purposes until either the property becomes substantially vested in the employee's hand or the employee makes a section 83(b) election." *Id.*

Lewis and Fuchs offered the following as a revision of Q/A-12:

> Except as provided in A-12 and A-13 of this section, a transfer of property is considered a payment made (or to be made) in the taxable year in which an individual acquires a beneficial ownership interest in the property transferred. Thus, in general, such a payment is considered made (or to be made) when the property is transferred (as defined in section 1.83-3(a)) to the disqualified individual. In such case, the amount of the payment is determined under section 83 and the regulations thereunder. Thus, in general, the amount of the payment is equal to the excess of the fair market value of the transferred property (determined without regard to any lapse restriction, as defined in section 1.83-3(i)) at the time that the individual receives a beneficial interest in such property, over the amount (if any) paid for the property.

Id. If the above revision is not accepted the authors suggested the following alternative:

> [A] payment occurs at the time of the grant of the shares if it can be established to his satisfaction that substantial indicia of ownership were transferred upon the award of shares of stock to a plan participant in accordance with the terms of an ongoing plan, and that the initial transfer occurred (i) in the ordinary course of the company's business; (ii) in accordance with the historic patterns of transfers under the plan; and (iii) without reference to any change in ownership or control. It could also require that the plan have been in effect and in operation before the effective date of section 280G.

Id.

71. *See* Prop. Treas. Reg. § 1.280G-1, Q/A-12(a), 54 Fed. Reg. at 19,396; *see also*

3. Nonqualified Options

The timing and amount of payment in the nature of compensation for nonqualified stock options with an ascertainable fair market value is determined by Q/A-13 of the proposed regulation.[72] The treatment of incentive stock options was, however, reserved for future regulations.[73] The nonqualified stock option is normally granted to executives at no cost. Consequently, executives do not have an investment at risk until the option is exercised. Furthermore, executives will allow the option to lapse if the value of the stock never exceeds the exercise price.

The tax consequences of nonqualified stock options are generally controlled by section 83. The proposed regulation looks to section 83 for determining when a nonqualified stock option is to be treated as a property transfer. If a nonqualified stock option has an ascertainable fair market value, the option is treated as property that is transferred "not later than the time at which the option becomes substantially vested."[74] While the proposed regulation provides that the value of an option with an ascertainable fair market value is to be determined by examining all the facts and circumstances involved,[75]

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id. § 1.280G-1, Q/A-12(d), 54 Fed. Reg. at 19,396. The example offered in Q/A-12(d) reads in pertinent part as follows:

> On January 1, 1986, Corporation M gives to A, a disqualified individual, in connection with his performance of services to Corporation M, a bonus of 100 shares of Corporation M stock. Under the terms of the bonus arrangement A is obligated to return the Corporation M stock to Corporation M unless the earnings of Corporation M double by January 1, 1989, or there is a change in ownership or control of Corporation M before that date. A's rights in the stock are treated as substantially nonvested [within the meaning of § 1.83-3(b)] during that period because A's rights in the stock are subject to a substantial risk of forfeiture [within the meaning of § 1.83-3(c)] and are nontransferable [within the meaning of § 1.83-3(d)]. On January 1, 1988, a change in the ownership of Corporation M occurs. On that day, the fair market value of the Corporation M stock is $250 per share. Since A's rights in the Corporation M stock become substantially vested [within the meaning of § 1.83-3(b)] on that day, the payment is considered made on that day, and the amount of the payment for purposes of this section is equal to $25,000 (100 x $250).

Id.

72. *See* Prop. Treas. Reg. § 1.280G-1, Q/A-13, 54 Fed. Reg. at 19,396.
73. *See id.* § 1.280G-1, Q/A-13(c), 54 Fed. Reg. at 19,396.
74. *See id.* § 1.280G-1, Q/A-13(a), 54 Fed. Reg. at 19,396.
75. *Id.* Factors relevant to the determination of the ascertainable fair market value at the time of the option include, but are not limited to, the following: "(1) The difference between the option's exercise price and the value of the property subject to option the time of vesting [*sic*]; (2) the probability of the value of such property increasing or decreasing; and (3) the length of the period during which the option can be exercised." *Id.*

the value of an option with a readily ascertainable fair market value is to be determined under Treasury Regulation section 1.83-7(b).[76]

D. Disqualified Individuals

1. Definition of Disqualified Individuals

The second requirement that has to be met before a payment will constitute a parachute payment is that the payment must be to, or for the benefit of, a disqualified individual.[77] As previously discussed, section 280G(c) defines a disqualified individual as "an employee, independent contractor or other person specified in regulations who performs personal services for any corporation," and "is an officer, shareholder or highly compensated individual."[78] The proposed regulation adds clarity and eases the burdens of tax advisors who were uncertain as to which individuals would be treated as a shareholder, an officer, or a highly compensated individual under the golden parachute provisions. Lack of guidance regarding the scope of the above terms, coupled with harsh penalties for employers and employees, has caused great anxiety for tax advisors and commentators.[79]

The individual must be both an employee or independent contractor and a shareholder, officer, or highly compensated individual at any time during the "disqualified individual determination period" in order to be a disqualified individual.[80] A "disqualified individual determination period" is the portion of the corporate year ending on the date of the change in ownership or control and the twelve-month period immediately preceding the change in ownership or control.[81] A corporation has the option of using its taxable year or the calendar year,[82] and therefore, may be able to exclude certain individuals as disqualified individuals. The corporation, however, may unintentionally have other employees included as disqualified

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76. *See id.*
77. *See id.* § 1-280G-1, Q/A-2(a), 54 Fed. Reg. at 19,394.
78. I.R.C. § 280G(c) (West Supp. 1991).
79. *See generally* J. EUSTICE, *supra* note 27, at 3-55; Krueger, *supra* note 4, at 849.
80. Prop. Treas. Reg. § 1.280G-1, Q/A-15, 54 Fed. Reg. at 19,396-97.
81. *See id.* § 1.280G-1, Q/A-20(a), 54 Fed. Reg. at 19,397.
82. *Id.* For example, suppose a change in ownership of Corporation T, a fiscal year taxpayer with a taxable year ending on September 30, takes place on October 9, 1988. Corporation T may elect as its "disqualified individual determination period" either the period beginning on January 1, 1987, and ending on October 9, 1988, or the period beginning on October 1, 1987, and ending on October 9, 1988. *Id.* § 1.280G-1, Q/A-20(b) Example (2), 54 Fed. Reg. at 19,397.

individuals during the determination period. This could occur if the corporation paid out bonuses at the beginning of its taxable year and the determination period covered two taxable years.

The "disqualified individual determination period" has been criticized as being arbitrary and causing unintentional exclusions and inclusions.[83] It has been suggested that a twelve-month period is adequate time to determine who is a disqualified individual.[84] Moreover, the relevant date should be the date the parachute agreement is made, not the date of change in ownership or control.[85] This modification in the proposed regulation would eliminate the arbitrary results and simplify the identification of disqualified individuals during the determination period.

2. Personal Service Corporations

A personal service corporation, or a similar noncorporate entity that would be a personal service corporation if it were a corporation, will be deemed to be an individual under section 280G.[86] If a corporation's principal activity is the performance of personal services, and such services are substantially performed by employee-owners, it is a personal service corporation.[87] The term "employee-owner" is defined by section 269A(b)(2) as an employee owning, at any time during the taxable year, more than ten percent of the corporation's outstanding stock, using an expanded version of constructive ownership under section 318(a)(2)(C).[88] Since the proposed regulation refers to section 269A for a definition of a personal service corporation and that section applies only to a narrow group of personal service corporations, a relatively small number of personal service corporations will be treated as individuals under the golden parachute rules.[89]

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83. *See* American Institute of Certified Public Accountants (AICPA) *AICPA Says That Golden Parachute Regulations Should Support the Validity of Failsafe Rules in Golden Parachute Agreements*, 44 TAX NOTES 861 (1989).
84. *See id.*
85. *See id.*
86. *See* Prop. Treas. Reg. § 1.280G-1, Q/A-16(a), 54 Fed. Reg. at 19,397.
87. *See* I.R.C. § 269A(b)(1) (West Supp. 1991).
88. *See id.* § 269A(b)(2).
89. *See generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 5-17 to 5-19 (5th ed. 1987). An example of a personal service corporation that should be treated as an individual is one with a single customer such as one organized by a doctor to supply his or her service to a hospital. *See also* I.R.C. § 448(d)(2) (West Supp. 1991) (providing a narrower definition of personal service corporations).

3. Shareholders

The proposed regulation contains the expected de minimis exception with respect to who will be treated as a "shareholder."[90] In order for a shareholder to be considered a disqualified individual, the individual must either actually or constructively own stock of the corporation, the fair market value of which exceeds one million dollars or one percent of the total fair market value of all the corporation's stock, whichever is less.[91] The American Bar Association Tax Section noted in its extensive recommendations that "the option attribution rules unfairly cause certain individuals to be considered disqualified individuals," and therefore, it suggested ignoring nonvested options when identifying "disqualified individuals."[92]

Under the proposed regulation, if an individual is an employee and shareholder at any time during the "disqualified individual determination period," he or she is considered a disqualified individual.[93] The definition of the determination period appears to require testing ownership on each day of such period. The final or temporary version of the proposed regulation should eliminate such a cumbersome and unnecessary administrative task by testing on one date—either when a change in ownership or control occurs or when the golden parachute agreement is executed.[94] In addition, the fair market value test which the proposed regulation has applied to shareholder's stock is arguably nonessential. The test does not give the individual the power over the corporation to such a degree that the corporation would provide him or her with extravagant parachute payments.[95]

4. Officers

The determination of whether an individual is an officer of the corporation is based on all the facts and circumstances in a particular case.[96] The facts which will be examined include the source of the individual's authority, the term for which the individual is elected or appointed, and the nature and extent of the individual's duties. In general, an "officer" means an administrative executive who has the authority that is customary of an officer and is in regular and

90. *See* Prop. Treas. Reg. § 1.280G-1, Q/A-17, 54 Fed. Reg. at 19,397; *see also* JOINT COMM. ON TAXATION, *supra* note 13, at 201.
91. *See* Prop. Treas. Reg. § 1.280G-1, Q/A-17, 54 Fed. Reg. at 19,397. Under this de minimis rule, § 318(a) determines constructive ownership of stock. *Id.*
92. *ABA Tax Section Members Recommend Changes to Golden Parachute Regulations*, 47 TAX NOTES 1297 (1990).
93. *See* Prop. Treas. Reg. § 1.280G-1, Q/A-15, 54 Fed. Reg. at 19,396-97.
94. *See* AICPA, *supra* note 83, at 861.
95. *See id.*
96. *See* Prop. Treas. Reg. § 1.280G-1, Q/A-18(a), 54 Fed. Reg. at 19,397.

continuous service.[97] The determination that an individual is an officer is based on the functions of the individual's job and not the individual's title.[98]

The broad definition of an officer for golden parachute agreements should be narrowed and clarified to reduce its expansive scope.[99] Moreover, since congressional concerns were dissimilar for golden parachutes, the temporary or final version of the proposed regulation should not use the same definition for officers found in the top heavy rules. Congress intended to define officers broadly for top heavy plans to prevent discrimination by creating a category that should not receive better tax treatment than rank and file employees. Social and tax policies are not met unless employer-provided retirement benefits are received by a broad group. If a sizable percentage of accrued benefits under a qualified retirement plan are appropriated for officers, then the plan is top heavy and subject to special restrictions. Congressional goals of minimizing disparate treatment could only be given effect by a broad definition of officers for top heavy plans. The same congressional view for a broad definition, however, was not present with regard to an officer in a golden parachute setting, as Congress was concerned with "top executives" and other "key personnel" who would use their considerable power in connection with any acquisition to receive a large payment or maintain their control at the expense of shareholders.[100] Therefore, an officer should be defined, for golden parachute purposes, to include only those individuals in the corporation experiencing a change in control, who have the power to influence their own benefits and the acquisition outcome.

The definition of an "executive officer" used by the rules promulgated under the Securities Exchange Act of 1934 is designed to include only those individuals who have the power to acquire inside information.[101] It has been recommended that due to similar

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97. *Id.*
98. *See id.*; *see also* Krueger, *supra* note 4, at 849.
99. *See* AICPA, *supra* note 83, at 861.
100. *See* JOINT COMM. ON TAXATION, *supra* note 13, at 199.
101. 17 C.F.R. § 240.3b-7 (1991). The rules under the Securities Exchange Act of 1934 define "executive officer" as follows:

> The term "executive officer," when used with reference to a registrant, means its president, any vice president of the registrant in charge of a principal business unit, division of function (such as sales, administration or finance), any other officer who performs a policy making function or any other person who performs similar policy making functions for the registrant. Executive officers of subsidiaries may be deemed executive officers of the registrant if they perform such policy making functions for the registrant.

Id.

policy objectives for the filing requirements of section 16 of the Securities Exchange Act of 1934[102] and section 280G, the definition of an officer for golden parachute payments should closely resemble the narrow definition of "executive officer" found in the securities rules.[103] This definition would generally include "the president, treasurer, secretary, any vice president in charge of a principal business unit, division or function (such as sales, finance or administration) or any other key policy making member of management."[104]

If an individual is an officer of any member of an affiliated group that is treated as one corporation under the proposed regulation,[105] that individual is an officer of the single corporation.[106] In addition, a limit is placed on the number of employees who will be considered disqualified individuals because they are officers of the corporation. No more than fifty employees (or if fewer, the greater of three employees or ten percent of the employees) will be classified as disqualified individuals because they are officers of the corporation.[107]

In making the preceding limitation, the corporation may use the greatest number of employees during the disqualified determination period.[108] Furthermore, if the number of officers is greater than the number of employees who may be considered officers under the proposed regulation, then the highest paid fifty employees (or if fewer, the greater of three employees or ten percent of the employees), based on compensation received during the disqualified individual determination period, are treated as officers.[109]

5. Highly Compensated Individuals

Section 280G(c) provides that the term "highly compensated individual" means any individual who is (or would be if the individual were an employee) a member of the group comprising the highest paid one percent of the employees or the highest paid 250 employees of the corporation, whichever is less.[110] The proposed regulation supplements the statutory definition by ranking on the basis of compensation paid during the disqualified individual determination

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102. 15 U.S.C. § 78p (1988).
103. *See* AICPA, *supra* note 83, at 861.
104. *Id.*
105. *See* Prop. Treas. Reg. § 1.280G-1, Q/A-46, 54 Fed. Reg. at 19,408.
106. *See id.* § 1.280G-1, Q/A-18(b), 54 Fed. Reg. at 19,397.
107. *See id.* § 1.280G-1, Q/A-18(c), 54 Fed. Reg. at 19,397.
108. *Id.*
109. *Id.*
110. I.R.C. § 280G(c) (West Supp. 1991).

period.[111] However, the proposed regulation does not resolve the ambiguity of whether or not independent contractors are to be included in the group of highest paid one percent or 250 employees.[112]

The proposed regulation provides that "no individual whose annualized compensation during the disqualified individual determination period is less than $75,000 will be treated as a highly compensated individual."[113] For example, if an individual only worked for two months at a salary of $6,000 per month during the disqualified individual determination period, the individual would not be treated as a highly compensated individual, since the individual's annualized compensation would be $72,000.

Brokers, attorneys, investment bankers, and similar independent service providers are not treated as highly compensated individuals, so long as certain conditions are met.[114] The services must be performed in their ordinary trade or business and the providers must perform similar services for a significant number of clients unrelated to the corporation undergoing a change in control.[115]

E. Contingent on Change in Ownership or Control

1. Contingent on Change

The third requirement necessary for a payment to be considered a parachute payment is that the payment must be contingent on a change in ownership or control of the corporation.[116] The proposed regulation states, "[i]n general, a payment is treated as 'contingent' on a change in ownership or control if the payment would not, in fact, have been made had no change in ownership or control oc-

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111. Prop. Treas. Reg. § 1.280G-1, Q/A-19(a), 54 Fed. Reg. at 19,397; *see also id.* § 1.280G-1, Q/A-21(a), (c), 54 Fed. Reg. at 19,397-98 (defining compensation as amounts which were payable by the corporation experiencing change in ownership or control, by a predecessor entity, or by a related entity). Compensation includes elective or salary reduction contributions to a cafeteria plan, cash or deferred arrangement, or tax sheltered annuity. However, compensation does not include compensation that was contingent on the change in ownership or control and was payable in the year of change. *Id.* § 1.280G-1, Q/A-21(a), (c), 54 Fed. Reg. at 19,397-98.

112. *See* Kafka & Hoenicke, *Reasonable Compensation*, 390 Tax Mgmt. (BNA) at A-20 (1987) (indicating that it is unclear whether independent contractors who technically are not employees are included in the testing pool).

113. Prop. Treas. Reg. § 1.280G-1, Q/A-19(a), 54 Fed. Reg. at 19,397.

114. *Id.* § 1.280G-1, Q/A-19(b), 54 Fed. Reg. at 19,397.

115. *Id.*

116. *See* I.R.C. § 280G(b)(2)(A)(i) (West Supp. 1991).

curred."[117] The proposed regulation also provides that property which becomes substantially vested because of a change in ownership or control will not be treated as a substantially certain payment.[118]

Generally, a payment will also be considered contingent on a change in ownership or control if the following conditions are present: (1) it is contingent on an event closely associated with the change; (2) a change actually occurs; and (3) the event is materially related to the change.[119] As to the first condition, a payment is treated as being contingent on an event that is closely associated with a change in ownership or control "unless it is substantially certain, at the time of the event, that the payment would have been made whether or not the event occurred."[120] If an event is of the kind that usually occurs before or after a change in ownership or control, the event is closely associated with the change.[121] The proposed regulation provides a list of examples that are treated as closely associated with a change in ownership or control.[122] A facts and circumstances test is applied to determine whether other events will be considered closely associated with such a change.[123] There is a presumption that an

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117. Prop. Treas. Reg. § 1.280G-1, Q/A-22(a), 54 Fed. Reg. at 19,398. Q/A-22(a) further explains this point as follows:

> A payment generally is to be treated as one which would not, in fact, have been made in the absence of a change in ownership or control unless it is substantially certain, at the time of the change, that the payment would have been made whether or not the change occurred.

Id.; *see also* JOINT COMM. ON TAXATION, *supra* note 13, at 201.

118. *See* Prop. Treas. Reg. § 1.280G-1, Q/A-22(a), 54 Fed. Reg. at 19,398.

119. *Id.* § 1.280G-1, Q/A-22(b), 54 Fed. Reg. at 19,398.

120. *Id.*

121. *Id.*

122. Q/A-22(b) offers the following examples:

> The onset of a tender offer with respect to the corporation; a substantial increase in the market price of the corporation's stock that occurs within a short period (but only if such increase occurs prior to a change in ownership or control); the cessation of the listing of the corporation's stock on an established securities market; the acquisition of more than five percent of the corporation's stock by a person (or more than one person acting as a group) not in control of the corporation; the voluntary or involuntary termination of the disqualified individual's employment; and a significant reduction in the disqualified individual's job responsibilities.

Id.

123. The following example appears in Q/A-22(e) Example (3) to illustrate the application of the facts and circumstances test:

> A contract between a corporation and a disqualified individual provides that a payment will be made to the individual if the corporation's level of product sales or profits reaches a specified level. At the time the contract was entered into, the parties had no reason to believe that such an increase in the corporation's level of product sales or profits would be preliminary or subsequent to, or otherwise closely

event is materially related to a change in ownership or control if it occurs within one year before or after the date of such change.[124]

If a change accelerates the time a payment is made, it is treated as contingent on a change in ownership or control even though the payment would have been made without the change.[125] For example, if a change accelerates the time of payment in cancellation of stock options, the payment may be treated as contingent on the change. Furthermore, a payment is treated as contingent on change in ownership even if the employment relationship of the disqualified individual is not terminated as a result of the change in ownership or control.[126] If the payment is made under a contract executed after a change in ownership or control, the payment will not be contingent on the change.[127] A contract that is executed after a change in ownership or control pursuant to a legally binding agreement that was consummated before the change, however, will be tainted and deemed to have been executed before the change.[128]

2. Amount of Payment Contingent on Change

Generally, the full amount of a payment is regarded as contingent on a change in ownership or control. However, the proposed regulation provides two exceptions to this general rule where only a portion of the payment is deemed as contingent on the change.[129] The first exception applies where it is substantially certain at the time

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associated with, a change in ownership or control of the corporation. Eighteen months later, a change in the ownership of the corporation occurs and within one year after the date of the change, the corporation's level of product sales or profits reaches the specified level. Under these facts and circumstances (and in the absence of contradictory evidence), the increase in product sales or profits of the corporation is not an event closely associated with the change in ownership or control of the corporation. Accordingly, even if the increase is materially related to the change, the payment will not be treated as contingent on a change in ownership or control.

This example shows that under the general rule, which treats a payment as contingent on a change in ownership or control, all three requirements must be satisfied. If one is not met, the payment will not be treated as contingent on change in ownership or control.

Id. § 1.280G-1, Q/A-22 Example (3), 54 Fed. Reg. at 19,398.

124. *See id.* § 1.280G-1, Q/A-22(b), 54 Fed. Reg. at 19,398; *see also id.* § 1.280G-1, Q/A-22(e) Examples (1)-(2), 54 Fed. Reg. at 19,398-99 (events presumed to be materially related to a change in ownership or control).
125. *Id.* § 1.280G-1, Q/A-22(c), 54 Fed. Reg. at 19,398.
126. *See id.* § 1.280G-1, Q/A-22(d), 54 Fed. Reg. at 19,398.
127. *Id.* § 1.280G-1, Q/A-23(a), 54 Fed. Reg. at 19,399.
128. *Id.*; *see also id.* § 1.280G-1, Q/A-23(b) Examples (1)-(2), 54 Fed. Reg. at 19,399.
129. *See id.* § 1.280G-1, Q/A-24(a), 54 Fed. Reg. at 19,399.

of the change that the payment would have been made regardless of whether the change had occurred, "but the payment is treated as contingent on the change solely because the change accelerates the time at which the payment is made."[130] Where this exception applies, the portion of the payment contingent on the change is the amount of the accelerated payment that is greater than the present value of the payment without acceleration.[131] Therefore, a payment accelerated by a change in ownership or control is not treated as contingent on the change if acceleration does not increase the present value of payment.

The proposed regulation further provides that if the future value of the payment without acceleration is not reasonably ascertainable, and acceleration of payment does not significantly increase the present value of the payment without acceleration, the present value without acceleration is deemed equal to the accelerated payment.[132] Consequently, in this factual context, no part of the payment is contingent on the change. In addition, the present value of a payment is determined on the date of the accelerated payment.[133]

The second exception to the general rule occurs in the case of a payment that is accelerated "by a change in ownership or control, and that was substantially certain, at the time of the change, to have been made without regard to the change if the disqualified individual had continued to perform services for the corporation for a specified period of time."[134] Under this exception, the portion of payment that is deemed to be contingent on the change is the lesser of (1) the accelerated payment amount, or (2) the amount by which the accelerated payment exceeds the present value of the payment without acceleration, plus an amount to consider the lapse of the obligation to continue performing services.[135] Moreover, if the future value of the payment is not reasonably ascertainable, the value of such payment is equal to the accelerated payment.[136]

A facts and circumstances test is used to ascertain the amount reflecting the lapse of the obligation to perform services.[137] The amount, however, will not be less than one percent of the accelerated payment multiplied by the number of full months between (1) the date when the payment is not subject to a substantial risk of forfeiture due to a change in ownership and control, and (2) the date it would

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130. *Id.* § 1.280G-1, Q/A-24(b), 54 Fed. Reg. at 19,399.
131. *Id.*; *see also id.* § 1.280G-1, Q/A-24(e) Example (1), 54 Fed. Reg. at 19,399.
132. *See id.* § 1.280G-1, Q/A-24(e) Example (3), 54 Fed. Reg. at 19,399.
133. *See id.* § 1.280G-1, Q/A-24(d), 54 Fed. Reg. at 19,399.
134. *Id.* § 1.280G-1, Q/A-24(c)(1), 54 Fed. Reg. at 19,399.
135. *Id.*
136. *Id.*
137. *See id.* § 1.280G-1, Q/A-24(c)(2), 54 Fed. Reg. at 19,399.

not have been subject to a substantial risk of forfeiture without acceleration.[138] Therefore, the value of the accelerated payment, plus one percent per month, is included in computing the parachute amount contingent on a change in ownership or control. The final or temporary version of the proposed regulation should clarify whether the minimum one percent calculation will provide a safe harbor for "parachuting" taxpayers.[139]

The proposed regulation's section concerning the amount of payment contingent on change has created considerable debate as to whether the section violates Congress' intent. One opponent has criticized the inclusion of only the value of the accelerated payment

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138. *Id.* The proposed regulation provides the following example to show the application of the second exception to treating the full amount of payment as contingent on change in ownership or control:

> On January 15, 1986, a corporation and a disqualified individual enter into a contract providing for a cash payment of $500,000 to be made to the individual on January 15, 1991. The payment is to be forfeited by the individual if he does not remain employed by the corporation for the entire 5 year period. However, the full amount of the payment is to be made immediately upon a change in the ownership or control of the corporation during the 5 year period. On January 15, 1989, a change in the ownership of the corporation occurs and the full amount of the payment ($500,000) is made on that date to the individual. Since the payment would have been made in the absence of the change if the individual had continued to perform services for the corporation until the end of the 5 year period, it is substantially certain, at the time of change, that the payment would have been made in the absence of the change, if the individual had continued to perform services for the corporation for a specified period of time. Therefore, only a portion of the payment is treated as contingent on the change. The portion of the payment that is treated as contingent on the change is the amount by which the amount of the accelerated payment (i.e. $500,000, the amount paid to the individual because of the change in ownership) exceeds the present value of the payment that was expected to have been made absent the acceleration (i.e. $406,838, the present value on January 15, 1989 of a $500,000 payment on January 15, 1991), plus an amount reflecting the lapse of the obligation to continue to perform services. Such amount will depend on all the facts and circumstances but in no event will such amount be less than $110,000 (1% x 22 months at ($500,000). Accordingly, the minimum amount of the payment treated as contingent on the change in ownership or control is $203,162 (($500,000 -$406,838) + $110,000). This result is not changed if the individual actually remains employed until the end of the 5 year period.

Id. § 1.280G-1, Q/A-24(e) Example (5), 54 Fed. Reg. at 19,400.

139. Ferrante, *Golden Parachute Should Provide More Examples*, 43 TAX NOTES 1333 (1989) (claiming that if taxpayers relied on one percent formula, it would have severe consequences in a tax audit where the IRS agent calculates a higher percentage).

plus one percent per month in the case of an option or stock appreciation right vesting on a change in ownership or control.[140] The opponent argues that the proposed regulation has, contrary to the legislative intent, adopted a taxpayer-favored approach for nonvested options and similar rights by treating "unvested compensation as earned to the extent the vesting period has run."[141] In fact, this same critic believes that the legislative history mandates including the entire value of the "suddenly vested option." The taxpayer-favored approach can have a dramatic impact on whether payments will be subject to the golden parachute penalties.[142]

This section's treatment of accelerated payments on nonvested options has been defended as a reasonable interpretation of the legislative history and the opponent's view has been labeled "misguided" by at least one commentator.[143] This proponent found statements in the legislative history indicating that Congress recognized that not all compensation paid at the time of a change was contingent on change.[144] Where it is substantially certain that the payment would have been made whether or not the change occurred, the inclusion of only part of the payment of a nonvested stock option accelerated

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140. *See* Sheppard, *18-Karat Parachutes; Treasury End Runs Congress*, 43 TAX NOTES 1198, 1198-1200 (1989).

141. *Id.* at 1199.

142. *Id.* Assume an executive has base compensation of $100,000. He has been granted stock options which have not vested. On the date of the change in control of his employer, the value of the spread on these options is $800,000, and there would have been another year left to go in the four-year vesting period but for the change in control. Suppose further that reasonable compensation for services rendered until the change in control would be $600,000. Under the proposed regulations, using an 11% discount rate, 22% of the $800,000 spread, or $176,000 would be included in the determination of whether the executive's parachute exceeded three times his base compensation of $100,000. Thus, the corporation could cash out all of the executive's options and give him an additional $124,000 on change in control with no tax penalty to either party. Regarding this example, Sheppard explains:

> The result in this example under the legislative history is that the full spread of $800,000 is included in the determination of whether the executive's parachute exceeded three times his base compensation of $100,000. Reasonable compensation of $600,000 then would be subtracted, leaving $200,000, less an amount representing the risk that the options would not vest, subject to the excise tax and non-deductible to the payor.

Id.

143. Abreu, *Treasury Should Be Lauded For The Golden Parachute Regulations*, 44 TAX NOTES 340, 340-42 (1989) (claiming that Ms. Sheppard's view is misguided because she does not recognize the distinction between compensation payable after passage of time and compensation payable upon a change in ownership control).

144. *Id.*; *see also* S. REP. No. 313, 99th Cong., 2d Sess. 916 (1986).

by a change in ownership or control in the parachute calculation appears to be the proper approach. The individual has earned at least part of the payment at the time of change in ownership or control, and it would be unreasonable to include the payment of the whole nonvested option. Therefore, the proposed regulation's treatment of the "suddenly vested option" is within legislative parameters and is reasonable.

Two commentators who support the inclusion of only part of the payment of a "suddenly vested option" used in Q/A-24(c) of the proposed regulation, recommend revision of the two-part formula used to calculate the amount of accelerated payment which will be treated as a parachute payment.[145] These commentators argue that the first part of the formula used to make an adjustment for the time value of money should be modified to allow a corporation to either: (1) determine the future value of its stock where there is adequate data of the financial condition of the corporation; or (2) if the future value of stock is not reasonably ascertainable, the value of stock at point of acceleration should be equal to its present value without a discount.[146] The commentators believe that the second part of the above formula attempts to make an adjustment for the contingency that the disqualified individual will not continue to perform services for the required period to achieve full vesting — that is, "earn out contingency." The commentators not only question the validity of the adjustment, but also believe that the application of both parts of the formula to the same payment constitutes a double penalty.[147]

Q/A-24(c) of the proposed regulation appears only to apply where there is an acceleration of both the payment and the vesting date. Where there is only an acceleration of the vesting date, however, there does not appear to be relief from the general rule requiring

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145. *See* Lewis & Fuchs, *supra* note 68, at 269.

146. *Id.* The commentators question the proposed regulation's position that the future value of stocks is not reasonably ascertainable. *See* Prop. Treas. Reg. § 1.280G-1, Q/A-24(e) Example 6(ii), 54 Fed. Reg. at 19,400 (assuming that the value of stock cannot be reasonably ascertained). Based on historic trends and availability of information, it is possible for large publicly held corporations to calculate the future value of their stock. Also, there may be enough information for closely held corporations to determine the future value of their stock. *See ABA Tax Section*, *supra* note 92, at 1297.

147. Lewis & Fuchs, *supra* note 68, at 269. If a minimum regulatory percentage is used it should be based on a rational index relating to employment and compensation matters (for example, Employment Cost Index). Since the first part of the formula requires discounting of the present value, they question whether any additional amount should be included in the parachute payment on account of nonperformance of services. *Id.*; *see also ABA Tax Section*, *supra* note 92, at 1297.

that the full amount of the payment be treated as contingent on the change.[148] For example, if one individual whose vesting date is accelerated elects a lump sum payment, the exception applies. If another individual whose vesting date was similarly accelerated elects an annuity, however, the exception apparently does not apply.[149] This section needs to be clarified or changed to treat the two individuals the same for tax purposes. It has been suggested that the exception found in Q/A-24(c)(2) should be used whether or not there is an acceleration of payment. If so, the two individuals would be in similar positions under the golden parachute rules.[150]

3. Presumption That Payment Is Contingent on Change

There is a presumption that payment is contingent on a change in ownership or control if the payment is made pursuant (1) to a contract entered into within one year before the date of a change, or (2) to an amendment that significantly modifies a previous contract, if the amendment is made within one year before the date of the change.[151] This presumption applies only to the part of payment made under the amendment that is greater than the amount of payment without the amendment.[152] The presumption may be rebutted, however, if the taxpayer is able to establish, by clear and convincing evidence based on all the facts and circumstances, that the payment is not contingent on the change.[153] Moreover, for an

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148. *See* Elinsky, *Elinsky Suggests Clarified Broader Exception to Golden Parachute Rules*, 43 TAX NOTES 1466 (1989); Schiffer, *MCN Corporation Asks For Expansion of Definition of Golden Parachute Payment*, 44 TAX NOTES 33 (1989); *see also ABA Tax Section*, *supra* note 92, at 1297.

149. *See* Elinsky, *supra* note 148, at 1466.

150. *Id.*

151. *Id.* § 1.280G-1, Q/A-25, 54 Fed. Reg. at 19,401.

152. *Id.*

153. *Id.* § 1.280G-1, Q/A-26(a), 54 Fed. Reg. at 19,401. Factors considered to rebut the presumption include:

> (1) The content of the agreement or amendment; and (2) the circumstances surrounding the execution of the agreement or amendment, such as whether it was entered into at a time when a takeover attempt had commenced and the degree of likelihood that a change in ownership or control would occur.

Id.; *see also* Sullivan v. Easco Corp., 662 F. Supp. 1396 (D. Md. 1987). The court in *Sullivan* held that the taxpayer had overcome, by clear and convincing evidence, the presumption that his compensation for services was contingent on a change in ownership even though it was paid pursuant to an agreement entered into within one year before the date of change in ownership or control. *Id.* at 1400. In support of its holding, the court noted that the compensation paid to the taxpayer was irrevocable and could be retained by him even if the change never occurred. Further, the court observed the taxpayer's base compensation was determined by referring to a consultant's report used by the

agreement executed within one year of the change, the presumption may be rebutted if the agreement is one of the three following types: (1) a "nondiscriminatory employee plan or program," (2) a contract that is a substitute for an earlier contract executed more than one year before the change, if the new contract does not provide for higher payments, accelerate the payment of amounts due in the future, or modify the terms of payments, or (3) a contract where the individual did not perform services before the individual's taxable year in which the change occurs, if the contract does not provide for payments significantly different in amount, timing, terms, or conditions from those provided under contracts executed by the corporation with other individuals performing comparable services.[154] It is important to note that even if the presumption is rebutted, the payment still may be contingent on a change in ownership or control under the general rules.[155]

4. Objective Tests

Neither section 280G nor its legislative history contains an objective test for determining when there is a change in the ownership or effective control of the corporation. The proposed regulation now offers an objective standard to make such determinations.

a. Change in Ownership or Control

A change in the ownership or control of a corporation occurs when any person, or persons "acting as a group," acquires stock that, together with stock already held by such person or group, exceeds fifty percent of the total fair market value or total voting power of the outstanding stock.[156] Persons will be deemed to be "acting as a group" if they own an entity that enters into a merger or similar business transaction with the corporation.[157] Persons will not be considered to be "acting as a group," however, solely because they own or purchase stock of the same corporation at the same time.[158] If any person or group owns more than fifty percent of the

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corporation before and without regard to the takeover. Consequently, the court viewed the agreement executed in view of the immediate takeover as merely setting the terms of compensation. *Id.* at 1401.

154. *Id.* § 1.280G-1, Q/A-26(b), 54 Fed. Reg. at 19,401.

155. *See id.* § 1.280G-1, Q/A-22, Q/A-26(b), 54 Fed. Reg. at 19,398, 19,401.

156. *See id.* § 1.280G-1, Q/A-27(a), 54 Fed. Reg. at 19,402; *see also id.* § 1.280G-1, Q/A-27(d) Example (1), 54 Fed. Reg. at 19,402 (change in ownership occurred due to acquisition of stock having a fair market value greater than 50% of the total stock of the corporation).

157. *See id.* § 1.280G-1, Q/A-27(b). For an illustration, *see id.* § 1.280G-1, Q/A-27(d) Example (3), 54 Fed. Reg. at 19,402.

158. *See id.* § 1.280G-1, Q/A-27(b), 54 Fed. Reg. at 19,402.

total fair market value or total voting power of stock of a corporation, the acquisition of more stock by the person or group is not a change in ownership or control.[159] It should also be noted that stock ownership will be determined under the constructive ownership rules as defined in section 318(a).[160]

b. Change in Effective Control

A change in the effective control of a corporation is presumed to take place when either: (1) any person or persons acting as a group acquires, or has acquired within twelve months ending on the most recent acquisition date, ownership of stock equal to or more than twenty percent of the total voting power of the stock of the corporation; or (2) a majority of the corporation's board of directors is replaced within any twelve-month period by directors whose appointment or election is not approved by a majority of the prior board of directors.[161] This presumption can be rebutted by establishing that such acquisition of the corporation's stock, or such replacement of the majority of the members of the corporation's board of directors, does not transfer control of management from any one person or group to another person or group.[162]

Without the acquisition of the corporation's stock or replacement of a majority on the board of directors, there is no presumption of a change in the effective control of a corporation.[163] Furthermore, if a person or group has effective control, the acquisition of more control is not treated as causing a change in the effective control of the corporation.[164] As is the case with the determination of change in ownership, persons will not be deemed as "acting as a group" merely because they purchase stock at the same time.[165] In addition, section 318(a) is also applicable for determining stock ownership when considering effective control.[166]

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159. *Id.* § 1.280G-1, Q/A-27(a), 54 Fed. Reg. at 19,402.
160. *See id.* § 1.280G-1, Q/A-27(c), 54 Fed. Reg. at 19,402.
161. *See id.* § 1.280G-1, Q/A-28(a), 54 Fed. Reg. at 19,402; *see also id.* § 1.280G-1, Q/A-28(e) Example (1), 54 Fed. Reg. at 19,402 (no presumption of a change in the effective control of a corporation when 20% of the voting stock is not acquired within a 12-month period).
162. *See id.* § 1.280G-1, Q/A-28(a), 54 Fed. Reg. at 19,402.
163. *Id.*
164. *Id.* § 1.280G-1, Q/A-28(b), 54 Fed. Reg. at 19,402.
165. *See id.* § 1.280G-1, Q/A-28(c), 54 Fed. Reg. at 19,402. Persons will be considered to be "acting as a group," however, if they are owners of an entity that merges or enters into a similar business transaction with the corporation. *Id.*
166. *Id.* § 1.280G-1, Q/A-28(d), 54 Fed. Reg. at 19,402.

c. Change in Ownership of a Substantial Portion of Assets

A change in the ownership of a substantial portion of a corporation's assets occurs when any person or group acquires, or has acquired within a twelve-month period ending on the most recent acquisition date, assets from the corporation with a total fair market value equal to or greater than one-third of the total fair market value of all the assets immediately before such acquisition or acquisitions.[167] Under the proposed regulation, the following corporate transfers of assets are not treated as a change in ownership: (1) a transfer to a shareholder of the corporation in exchange for or with respect to its stock, (2) a transfer to an entity where fifty percent or more of the total value or voting power is either directly or indirectly owned by the corporation, (3) a transfer to a person or group that owns fifty percent or more of the total value or voting power of all the outstanding stock of the corporation, and (4) a transfer to an entity where fifty percent or more of the total value or voting power is directly or indirectly owned by a person or entity described in (3).[168] Generally, a person's status is determined immediately after the transfer of assets.[169]

If a transaction is a stock or asset sale, the objective test for determining whether there is a change of ownership or control must be made with respect to the "corporation," thus, the definition of a "corporation" is a critical issue. Section 280G(d)(5) and Q/A-46 of the proposed regulation both provide that members of the same affiliated group are deemed to be one corporation.[170] Furthermore, under Q/A-46, one corporation treatment for members of an affiliated group influences the change in ownership or control rules.

The affiliation rules of Q/A-46 can, in certain situations, control whether the golden parachute rules apply. For example, suppose *D*, a member of the *ABCD* affiliated group, has an incentive compensation plan for employees in the event *D* is sold. The fair market value of *D*'s assets is less than one-third of the fair market value of *ABCD*'s assets. If *D* and the other members of the *ABCD* affiliated group are treated as one group, the sale of *D*'s assets should not cause a change in ownership, since the *ABCD* group would not be disposing of one-third of its assets. Therefore, no parachute payments will have been made under the golden parachute rules, even though

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167. *Id.* § 1.280G-1, Q/A-29(a), 54 Fed. Reg. at 19,403.
168. *Id.* § 1.280G-1, Q/A-29(b), 54 Fed. Reg. at 19,403; *see also id.* § 1.280G-1, Q/A-29(d) Example (3), 54 Fed. Reg. at 19,403 (examines when a transfer in assets is not considered a change in ownership of a substantial portion of the assets of a corporation).
169. *Id.* § 1.280G-1, Q/A-29(b), 54 Fed. Reg. at 19,403.
170. *See* I.R.C. § 280G(d)(5) (West Supp. 1991); Prop. Treas. Reg. § 1.280G-1, Q/A-46, 54 Fed. Reg. at 19,408.

a payment contingent on a sale has been triggered. However, if the same fact pattern was tested without benefit of the affiliation rules, a sale of *D*'s assets would result in a change of ownership activating the golden parachute rules.

Section 280G(d)(5) and the proposed regulation indicate that in testing for a change in ownership or control an affiliated group of corporations is treated as one corporation. Because of the importance of the affiliated rules in this area, the temporary or final version of the regulation should have examples of the interaction of the affiliation rules and golden parachute provisions.

F. Mathematical Test

1. Threshold Amount

Even if a payment to a disqualified individual is in the nature of compensation and contingent on a change in ownership or control, it still might not be a parachute payment. The final requirement for the payment to be considered a parachute payment is that the aggregate present value of such payment must equal or exceed three times the individual's base amount.[171] If this threshold amount is not exceeded, no part of the payment is a parachute payment.[172] Also, if securities violation parachute payments are not contingent on a change in ownership or control, they are not to be included in the mathematical test.[173]

2. Determination of Present Value

Under Q/A-31 of the proposed regulation, "the present value of a payment is determined as of the date on which the change in ownership or control occurs, or, if a payment is made prior to such date, the date on which the payment is made."[174] This section has been criticized as violating the spirit of Congress' intent since it requires that present values be calculated at the time of a change in control, rather than as each change in control payment becomes payable.[175] A discount rate equal to 120 percent of the applicable

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171. *See* I.R.C. § 280G(b)(2)(A)(ii) (West Supp. 1991); *see also* Prop. Treas. Reg. § 1.280G-1, Q/A-30(a), 54 Fed. Reg. at 19,403; *id.* § 1.280G-1, Q/A-30(b) Example (1), 54 Fed. Reg. at 19,403 (fact pattern showing the application of the mathematical test).
172. *See* Prop. Treas. Reg. § 1.280G-1, Q/A-30(b) Example (2), 54 Fed. Reg. at 19,403.
173. *See id.* § 1.280G-1, Q/A-30(a), 54 Fed. Reg. at 19,403.
174. *Id.* § 1.280G-1, Q/A-31, 54 Fed. Reg. at 19,403.
175. *See* Ferrante, *supra* note 139, at 1333.

federal rate[176] compounded semiannually is employed to determine present value.[177] Generally, the applicable federal rate used for the calculation is the rate in effect on the date the present value is ascertained.[178] The disqualified individual and corporation may elect, however, to use the applicable federal rate at the date the contract is executed, if the election is part of the contract.[179] If multiple contracts executed on different dates provide for an accelerated payment and vesting on a change in ownership or control, it is unclear whether separate applicable federal rate elections can be made for each contract.[180]

If the present value of a payment is contingent on an uncertain future event or condition, a reasonable estimate of the time and amount of the future payment is made and the present value will be calculated based on this estimate.[181] An uncertain future event or condition, however, will not be taken into account to reduce the present value of a payment, unless the possibility of the event or condition can be ascertained by using generally accepted actuarial principles.[182] When such future payment is made, or is certain not to be made, the mathematical test is reapplied to show the actual time and amount of the payment.[183] Furthermore, whenever the mathematical test is applied, the aggregate present value of the payments received, or to be received, is redetermined[184] as of the present value date[185] using the discount rate.[186] This redetermination may have an impact on the amount of an excess parachute payment for an earlier tax year, and therefore, may necessitate the filing of amended tax returns. It is unclear what happens when the redetermination is made after the statute of limitations has expired and the taxpayer is entitled to a refund.[187]

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176. *See* I.R.C. § 1274(d) (West Supp. 1991) (provision for determining the applicable federal rate).
177. *See* Prop. Treas. Reg. § 1.280G-1, Q/A-32, 54 Fed. Reg. at 19,403.
178. *Id.*
179. *Id.*
180. *See* Ferrante, *supra* note 139, at 1333.
181. Prop. Treas. Reg. § 1.280G-1, Q/A-33(a), 54 Fed. Reg. at 19,404.
182. *Id.*; *see also* Prop. Treas. Reg. § 1.280G-1, Q/A-33(c) Example (2), 54 Fed. Reg. at 19,404.
183. *Id.* § 1.280G-1, Q/A-33(b), 54 Fed. Reg. at 19,404; *see also id.* § 1.280G-1, Q/A-33(c) Example (3), 54 Fed. Reg. at 19,404.
184. *See id.* § 1.280G-1, Q/A-33(b), 54 Fed. Reg. at 19,404; *see also id.* § 1.280G-1, Q/A-33(c) Example (3), 54 Fed. Reg. at 19,404.
185. *See id.* § 1.280G-1, Q/A-31, 54 Fed. Reg. at 19,403.
186. *See id.* § 1.280G-1, Q/A-32, 54 Fed. Reg. at 19,403.
187. *See* Ferrante, *supra* note 139, at 1333 (questioning whether redetermination is a waiver of the statute of limitations and whether mitigation applies).

3. Base Amount

The base amount is the average annual compensation includable in the gross income of the disqualified individual for the taxable years in the "base period."[188] "Compensation" is defined as that compensation which is payable by a corporation that experiences a change in ownership or control, by a "predecessor entity," or by a "related entity."[189] Compensation also includes "elective or salary reduction contributions to a cafeteria plan, cash or deferred arrangement, or tax-sheltered annuity."[190] This could be interpreted to mean that elective deferrals or salary reduction contributions are included in compensation, and thus in the disqualified individual's "base amount" in the year that the deferred compensation is earned. However, Q/A-34(a) of the proposed regulation provides that the base amount is the average annual compensation which was "includable" in gross income.[191] This language, which is consistent with section 280G's legislative history,[192] appears to require that compensation be included in the base amount during the taxable year it is actually or constructively received and not in the year the compensation is earned.[193]

If the deferred compensation or similar amounts of compensation are not included in the base amount, the individual's base amount may be significantly lower than the individual's actual compensation during the base period.[194] Consequently, with a lower base amount it may be easier for the individual with such compensation to be subject to the golden parachute penalties. Commentators have been critical of this disparate treatment for permitted deferrals and current compensation.[195]

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188. Prop. Treas. Reg. § 1.280G-1, Q/A-34(a), 54 Fed. Reg. at 19,404. *See infra* note 198 and accompanying text for the definition of "base period."

189. *See id.*; *see also id.* § 1.280G-1, Q/A-21(a), 54 Fed. Reg. at 19,397-98. Q/A-21 defines a "predecessor entity" as "any entity which, as a result of a merger, consolidation, purchase or acquisition of property or stock, corporate separation, or other similar business transaction transfers some or all of its employees to the changed corporation or to a related entity or to a predecessor entity of the changed corporation." *Id.* § 1.280G-1, Q/A-21(b), 54 Fed. Reg. at 19,398.

190. *Id.* § 1.280G-1, Q/A-21(a), 54 Fed. Reg. at 19,398.

191. *See id.* § 1.280G-1, Q/A-34(a), 54 Fed. Reg. at 19,404.

192. *See* H.R. REP. No. 861, 98th Cong., 2d Sess. 850 (1984); JOINT COMM. ON TAXATION, *supra* note 13, at 200.

193. *See* Krueger, *supra* note 4, at 849.

194. *See* Kafka & Hoenicke, *supra* note 112, at A-21.

195. *See* Hewitt, *Associate Recommends Changes In Treatment of Vested Deferred Compensation in Golden Parachute Regulations*, 44 TAX NOTES 269 (1989); Kanter, *Consultant Suggests Refinement For Golden Parachute Payment Computations*, 44 TAX NOTES 270 (1989); Kesner, *Kesner Suggests Changes in Golden Parachutes Governing Payments, Base Amounts, and Reasonable Compensation*, 44 TAX NOTES 269 (1989).

The interaction between Q/A-34(a) and Q/A-21 should be clarified regarding this point.[196]

4. Base Period

The "base period" is defined as the five most recent taxable years of the individual "ending before the date of the change in ownership or control."[197] If the disqualified individual performed personal services for the corporation or other entity for only a portion of the five-year period, however, only that portion of the five-year period becomes the base period.[198] If the base period is a short taxable year, compensation for the short taxable year must be annualized before calculating the average annual compensation for the base period.[199] Compensation paid only once a year, however, is not annualized.[200] For example, a "sign-up" bonus would not be annualized because it is paid only once a year. If it can be established that a "sign-up" bonus is not contingent on a change in ownership or control, then such a bonus may be utilized to increase a taxpayer's base amount so that no part of the payment is a parachute payment.[201]

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196. *See* Smith, *Long-Term and Short-Term Should use Same Wage Base for Golden Parachute Formulas*, 43 TAX NOTES 1466 (1989) (concluding that since elective deferrals are eventually included in gross income, the intention is to permit their inclusion); Ferrante, *supra* note 139, at 1333 (requesting clarification of interaction between Q/A-34 and Q/A-21 as cross reference on deferred compensation).
197. Prop. Treas. Reg. § 1.280G-1, Q/A-35(a), 54 Fed. Reg. at 19,404.
198. *Id.*; *see also id.* § 1.280G-1, Q/A-35(b) Examples (1)-(2), 54 Fed. Reg. at 19,404-05 (calculating of the base amount where a disqualified individual performed personal services for a part of the five-year period).
199. *Id.* § 1.280G-1, Q/A-34(b), 54 Fed. Reg. at 19,404.
200. *See id.*
201. *Id.* § 1.280G-1, Q/A-36(b), 54 Fed. Reg. at 19,405. For example, T, an individual, who files on the calendar year, executes a four-year employment contract with Corporation W as an officer of the corporation. T has not previously rendered services for Corporation W (or any related or predecessor entity). Pursuant to the employment contract, T is to receive a salary of $96,000 for each of the four years that he is employed by the Corporation with any remaining unpaid balance to be paid immediately if T's employment is terminated without cause. After T has been employed for only six months and received compensation of $48,000, a change in ownership occurs. Because of the change, T's employment is terminated without cause and he receives a payment of $336,000. It is shown by clear and convincing evidence that the $48,000 in compensation is not contingent on the change in ownership or control, but the presumption is not rebutted with respect to the $336,000 payment. Consequently, the payment of $336,000 is treated as contingent on the change in ownership of Corporation W. In this fact pattern, T's base amount is $96,000 (2 x $48,000). Since the present value of the payment which is contingent on the change in ownership of Corporation W ($336,000) is more than three times T's base amount of $96,000 (3 x $96,000 = $288,000), the

The proposed regulation has been criticized as being discriminatory to the long-term employee who must "annualize" a longer earning history while a short-term employee can annualize a period as short as the prior year.[202] Higher salaries in the most recent period will result in short-term employees having higher base amounts, and therefore, making them less likely to be caught in a defective parachute. The proposed regulation should also contain more examples that address whether or not commonly drafted agreements seeking to avoid the golden parachute penalties will be respected by the Internal Revenue Service.[203] Provision of such examples may reduce the submission of private letter ruling requests and thus reduce the Internal Revenue Service's burden of response.[204]

G. Securities Violation Parachute Payments

A "securities violation parachute payment" is any payment that is in the nature of compensation paid to a disqualified individual in connection with a potential or actual change in ownership or control and is made pursuant to an agreement that violates any "generally enforced" federal or state securities law or regulation.[205] If the violation is technical in nature or is not materially prejudicial to shareholders, it is not a securities violation parachute payment.[206] A securities violation is presumed not to exist unless the violation is

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payment is a parachute payment.

The result would be different if T had also received a "sign-up" bonus of $40,000 from Corporation W on the first day of the employment contract. It is shown by clear and convincing evidence that the bonus is not contingent on the change in ownership. In six months, when the change in ownership occurs, T has received compensation of $88,000 (the $40,000 bonus + $48,000 in salary). Now, T's base amount is $136,000 ($40,000 + (2 x $48,000)). Since the $40,000 will not be paid more than once a year, the amount of the bonus is not increased in annualizing T's compensation. The present value of the potential parachute payment ($336,000) is less than three times T's base amount of $136,000 (3 x $136,000 = $408,000), and therefore no part of the payment is a parachute payment. *See id.* § 1.280G-1, Q/A-36(b) Examples (1)-(2), 54 Fed. Reg. at 19,405.

202. *See* Smith, *supra* note 196, at 1466.

203. Ferrante, *supra* note 139, at 1333 (questioning whether agreements attempting to avoid golden parachute status by treating any payments in excess of a 2.99 base amount cap as loans will be respected).

204. *See* Rev. Proc. 89-34, 1989-1 C.B. 917. The Service is examining how to maximize current resources to more efficiently provide public guidance. *See also* Rev. Proc. 89-104, 1989-35 I.R.B. 19 (requesting comments on private letter rulings policy); Rev. Proc. 89-105, 1989-35 I.R.B. 20 (answering questions concerning Rev. Proc. 89-34).

205. Prop. Treas. Reg. § 1.280G-1, Q/A-37(a), 54 Fed. Reg. at 19,405.

206. *See id.*

determined or admitted in a civil, criminal, or administrative action resolved by adjudication or consent.[207]

If securities violation parachute payments are not contingent on a change in ownership or control, they are deemed to be parachute payments regardless of the three-times-base-amount test.[208] Moreover, if the payment is not contingent on change in ownership or control, reasonable compensation for past services actually performed before the change will not reduce the amount of the securities violation parachute payment treated as an excess parachute payment.[209] Likewise, reasonable compensation for services to be performed on or after the date of change is included in the amount of a securities violation parachute payment if such payment is not contingent on the change.[210]

The above-mentioned rules are applied to securities violation parachute payments that are contingent on a change in ownership or control, if the rules produce greater total excess parachute payments than would be produced if the payments were simply treated as payments contingent on a change in ownership or control.[211] For example, if a disqualified individual receives two payments in the nature of compensation that are contingent on a change in ownership or control with only the second being a securities violation, that payment is treated as a securities violation parachute payment subject to the securities violation parachute payment rules and not simply as a payment contingent on change in ownership or control where the amount of the excess parachute payment is increased.[212] If the second payment's treatment as a payment contingent on change in ownership or control would produce a greater excess parachute payment, then it would be treated as a payment contingent on change in ownership or control and not as a securities violation parachute payment.[213]

H. Exempt Payments

Four types of payments are exempt from the definition of parachute payment: (1) payments from a small business corporation, (2) certain payments from a corporation that has no stock which is readily tradeable on an established securities market, (3) payments to or from a qualified plan, and (4) certain payments of reasonable compensation.[214] Section 280G(a) does not disallow deductions for

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207. *See id.*
208. *Id.* § 1.280G-1, Q/A-37(b), 54 Fed. Reg. at 19,405.
209. *Id.*
210. *Id.*
211. *Id.* § 1.280G-1, Q/A-37(c), 54 Fed. Reg. at 19,405.
212. *See id.* § 1.280G-1, Q/A-37(d) Example (1), 54 Fed. Reg. at 19,405.
213. *See id.* § 1.280G-1, Q/A-37(d) Example (2), 54 Fed. Reg. at 19,405.
214. *Id.* § 1.280G-1, Q/A-5, 54 Fed. Reg. at 19,394.

exempt payments and the twenty-percent excise tax of section 4999 will not apply to exempt payments.[215] Moreover, exempt payments will not be taken into account for purposes of the three-times-base-amount test.[216]

1. Payments to Closely Held Corporations

a. Small Business Corporations

Payments received by a disqualified individual, even though greater than the threshold amount, will not be parachute payments if received from a corporation which was a small business corporation immediately before the change in ownership or control.[217] A small business corporation is defined as a corporation that: (1) does not have more than thirty-five shareholders; (2) does not have a shareholder who is not an individual (other than an estate or qualifying trust); and (3) does not have more than one class of stock.[218] Therefore, a Subchapter C corporation that is eligible to elect Subchapter S status without the nonresident alien shareholder restriction is a small business corporation. As previously discussed, the Tax Reform Act of 1986 originally contained a restriction that a small business corporation could not have a nonresident alien as a shareholder, but this restriction was removed in 1988.[219]

One commentator has offered the suggestion that the thirty-five shareholder rule should be a "flexible guideline, not a bright-line test," because such a test may reduce the number of employees who will be offered stock and thirty-five shareholders may not be the best evidence of a closely held corporation.[220] While a flexible guideline may deal with the concerns raised by this commentator, it will also add uncertainty and impose an administrative burden on the courts to determine whether a particular fact pattern fits within the guideline. Moreover, the number of shareholders is based on the Sub-

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215. *Id.*
216. *Id.*
217. *See id.* § 1.280G-1, Q/A-6(g) Example (1), 54 Fed. Reg. at 19,394-95.
218. I.R.C. § 1361(b)(1)(A), (B), (D) (West Supp. 1991).
219. *See* I.R.C. § 280G(b)(5)(A)(i) (West Supp. 1987) (amended in 1988).
220. *See* Curtis, *Thirty-Five-Shareholder Test for Exemption from Parachute Payments Should be Flexible*, 44 TAX NOTES 159 (1989). For example, Mr. Curtis states:

> Assume that a corporation with 34 shareholders decides to transfer a minimal amount of stock to two of its key employees. Under a strict bright-line test, this corporation would now be subject to the parachute payment, while a less enlightened but otherwise identical corporation that did not transfer stock to its employees would not be.

Id. at 159.

chapter S rule which has been increased in the past, and if increased in the future, the larger number may also apply to the small business corporation exception.[221]

b. Other Closely Held Corporations

The second type of corporate payments to a disqualified individual exempt from classification as a parachute payment occurs if (1) immediately before the change in ownership or control, no stock in the corporation was readily tradeable on an established securities market, and (2) shareholder approval requirements are met with respect to such payment.[222] The term "stock" under the no-market requirement does not include certain preferred stock, providing the payment does not have an adverse impact on the redemption and liquidation rights of any stock owned by shareholders.[223] Stock is readily tradeable for purposes of the no-market requirement when it is quoted on a regular basis by brokers or dealers making a market in such stock.[224]

If a substantial portion of the assets of any other entity is composed (directly or indirectly) of stock in the corporation making the payments, and any ownership interest in such other entity is readily tradeable on an established securities market, the corporation will fail to meet the no-market requirement.[225] The stock will be a "substantial portion of the assets" in the other entity, if the total fair market value of the stock is equal to or greater than one-third of the total fair market value of all the assets of the entity.[226] Furthermore, if a corporation is a member of an affiliated group, the no-market requirement is not satisfied where stock in any member

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221. Subchapter S of the code, as originally enacted in 1958, had a limit of 10 shareholders. The shareholder limit has been increased several times since 1958.
222. Prop. Treas. Reg. § 1.280G-1, Q/A-6(a)(2), 54 Fed. Reg. at 19,394.
223. Prop. Treas. Reg. § 1.280G-1, Q/A-6(d), 54 Fed. Reg. at 19,394; *see also* I.R.C. § 1504(a)(4) (West Supp. 1991). Under § 1504(a)(4), the term "stock" does not include any stock which:
    (A) is not entitled to vote,
    (B) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent,
    (C) has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium), and
    (D) is not convertible into another class of stock.
    I.R.C. § 1504(a)(4) (West Supp. 1991).
224. Prop. Treas. Reg. § 1.280G-1, Q/A-6(e), 54 Fed. Reg. at 19,394.
225. *Id.* § 1.280G-1, Q/A-6(c), 54 Fed. Reg. at 19,394; I.R.C. § 280G(b)(5)(A)(ii) (West Supp. 1991) (giving the Secretary power to issue regulations); *see also*, S. REP. No. 313, 99th Cong., 2d Sess. 918 (1986).
226. Prop. Treas. Reg. § 1.280G-1, Q/A-6(c), 54 Fed. Reg. at 19,394.

of the group trades readily on an established securities market.[227] One commentator makes a persuasive argument that Congress did not intend to create this result, and suggests an amendment to the proposed regulation which would reflect a more reasonable exemption.[228] It has been recommended by another commentator that the exemption should be applicable where there is an affiliated group of corporations and the only member that has readily tradeable stock is a foreign corporation whose shares are traded only on foreign securities exchanges.[229]

Shareholder approval requirements are met if: (1) the persons who owned, immediately before the change in ownership or control, more than seventy-five percent of the voting power of all outstanding stock of the corporation approved of the payment, and (2) there was adequate disclosure of all material facts concerning the payments to all persons entitled to vote.[230] It is unclear whether a vote for each individual receiving a payment or a separate vote from other corporate action is required under the proposed regulation.[231] This ambiguity should be resolved in the final or temporary version of the regulation. Adequate disclosure must be a full and truthful revelation of the material facts and other information so the disclosure, when made, is not materially misleading.[232] Moreover, omission of a fact is deemed material, if there is a substantial probability that a reasonable shareholder would regard it as important.[233]

The proposed regulation indicates that the shareholder vote must determine the right of the disqualified individual to receive the payment, or in the case of payment made before the vote, the right of the individual to retain the payment.[234] Section 280G(b)(5)(B)(i)

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227. *Id.*

228. *See* Holtz, *Holtz Suggests Exemption to Golden Parachute Rules Covering Nonreadily Tradeable Stock*, 44 TAX NOTES 269 (1989). Holtz recommends that Q/A-6(c) of the proposed regulation be changed as follows:

> If a corporation is a member of an affiliated group (which group is treated as one corporation under A-46 of this section) *and a substantial portion of the assets of such affiliated group consists (directly or indirectly) of stock in such corporation*, the requirements of paragraph (a)(2)(i) of this A-6 are not met if any stock in any member of such group is readily tradeable on an established securities market or otherwise.

Id. at 269 (emphasis in original).

229. *See* Morse, *Morse Suggests Exemption to Golden Parachute Rules for Stock Transfers Connected to Readily Tradeable Foreign Stock*, 44 TAX NOTES 269 (1989).

230. *See* Prop. Treas. Reg. § 1.280G-1, Q/A-7(a), 54 Fed. Reg. at 19,395.

231. *See* Dunn, *Ropes & Gray Suggests Changes in Shareholder Approval Vote Rules for Exceptions to Parachute Payments*, 44 TAX NOTES 159 (1989).

232. Prop. Treas. Reg. § 1.280G-1, Q/A-7(d), 54 Fed. Reg. at 19,395.

233. *Id.*

234. *Id.* § 1.280G-1, Q/A-7(a)(2), 54 Fed. Reg. at 19,395.

of the code provides only for shareholder approval of the payments and does not have similar language empowering the shareholders in a tax matter to determine whether the individuals will receive or retain payments.[235] In addition, the legislative history shows no evidence of the language in the proposed regulation.[236] Commentators have made note of this dramatic and far reaching language in the proposed regulation and have requested a revision or deletion.[237] Furthermore, in the case of payment made before the vote, the right of a disqualified individual to retain the payment has been construed to provide authority for retroactive shareholder approval.[238]

The approval of any payment by an "entity shareholder" must generally be made by the person authorized to approve the payment.[239] If a substantial portion of the assets of such an entity shareholder is composed of stock in the corporation experiencing the change in ownership or control, however, a separate vote, by persons holding more than seventy-five percent of the entity shareholder's voting power immediately before the change, must approve a payment

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235. *See* I.R.C. § 280G(b)(5)(B)(i) (West Supp. 1991).

236. *See* S. REP. No. 313, 99th Cong., 2d Sess. 919 (1986).

237. *See* Schmehl, *New Shareholder Approval Requirements for Golden Parachute Payments Are Unnecessary*, 43 TAX NOTES 1583 (1989). Mr. Schmehl believes that the proposed regulation gives the appearance of an attempt by the Treasury Department to make corporate law through a Treasury Regulation. Requiring the vote to determine receipt or retention will cause many practical problems. For example:

> A, a disqualified individual, has entered into a five year employment contract with Corporation T, a privately held corporation. Corporation P desires to purchase the stock of T but wants T to first negotiate a buy-out of the employment contract of A. T negotiates a lump sum buy-out of the contract. The payment will be contingent on a change in control and without mitigation of damage provisions in the buy-out may otherwise be a parachute payment. T seeks shareholder approval of the payment. Pursuant to the language of A-7, for this approval to be valid the approval must determine whether A will receive the payment or not. If the payment cannot be made, the stock purchase by P will not occur.

Id. at 1583. Moreover, he notes that in some situations the payment to a disqualified individual must be made by a contract and shareholders have no say in whether the payments will be made. *Id.*

See also Dunn, *supra* note 231, at 159. Ms. Dunn says the code and legislative history merely require shareholder approval of the payment. In addition, she refers to similar language in § 422A with respect to incentive stock options and notes that this section does not require that the options will be granted only if shareholders approve. Section 280G should be construed in a similar manner with regard to the statutory approval language. *Id.*

238. *See* Wellen, *Clarification of Retroactive Shareholder Approval of Golden Parachute Payments*, 44 TAX NOTES 268 (1989).

239. *See id.* § 1.280G-1, Q/A-7(b), 54 Fed. Reg. at 19,395.

by that entity.[240] This rule does not apply, however, where the value of the stock owned by or for the entity shareholder is not greater than one percent of the value of the outstanding stock of the corporation.[241] In addition, where approval of a payment by an entity shareholder must be made by a separate vote, the entity shareholder's normal voting rights determine which owners shall vote.[242]

2. Payments Under Qualified Plans

The proposed regulation and section 280G both provide that the term "parachute payment" does not include any payment to or from: (1) a plan described in section 401(a), including a trust exempt from tax under section 501(a); (2) an annuity plan described in section 403(a); or (3) a simplified employee pension plan as defined in section 408(k).[243] It would appear that Congress intended to exempt rollovers of distributions from a former employer's plan to the new employer's plan.[244]

3. Payments of Reasonable Compensation

Payments of reasonable compensation which the disqualified individual demonstrates by clear and convincing evidence are for

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240. *Id.*; *see also* S. REP. No. 313, 99th Cong., 2d Sess. 918 (1986). Congress intended that this rule would prevent the creation of tiers of entities to avoid golden parachute penalties by taking advantage of the exemption for shareholder approval. It stated: "Such avoidance is possible if the gross value of the entity-shareholder's interest in the corporation constitutes a substantial portion of such entity's assets." *Id.*

241. Prop. Treas. Reg. § 1.280G-1, Q/A-7(b), 54 Fed. Reg. at 19,395.

242. *Id*; *see also id.* § 1.280G-1, Q/A-7(e) Example (2), 54 Fed. Reg. at 19,395. Q/A-7(c) of the proposed regulation, regarding shareholder approval requirements, states that:

> the "more than 75 percent" group referred to in paragraph (a)(1) of this A-7, stock is not counted as outstanding stock if the stock is actually owned or constructively owned under section 318(a) by or for a disqualified individual who receives (or is to receive) payments that would be parachute payments if the shareholder approval requirements described in paragraph (a) of this A-7 were not met. Likewise, stock is not counted as outstanding stock if the owner is considered under section 318(a) to own any part of the stock owned directly or indirectly by or for a disqualified individual described in the preceding sentence. However, if all persons who hold voting power in the corporation or the entity shareholder are disqualified individuals or related persons described in either of the two preceding sentences, the stock owned by such persons is counted as outstanding stock.

Id. § 1.280G-1, Q/A-7(c), 54 Fed. Reg. at 19,395.

243. *Id.* § 1.280G-1, Q/A-8, 54 Fed. Reg. at 19,395; I.R.C. § 280G(b)(6) (West Supp. 1991).

244. *See* Kafka & Hoenicke, *supra* note 112, at A-24.

personal services to be performed on or after the change in ownership or control are exempt from the definition of parachute payments.[245] This exemption, however, does not apply to securities violation parachute payments.[246] Furthermore, reasonable compensation for personal services actually performed may reduce excess parachute payments, but will not exempt the payments from parachute payment classification. In most reasonable compensation cases, taxpayers can normally prove reasonableness by a preponderance of the evidence. The clear and convincing standard, on the other hand, is a much heavier burden for the taxpayers in parachute payment matters.[247]

I. Determination of Reasonable Compensation

1. General Rules

All the facts and circumstances in a specific case are to be considered when deciding whether payments are reasonable compensation for past or future personal services of the disqualified individual.[248] Moreover, if the taxpayer shows that payments, for past or future personal services, are made under a nondiscriminatory employee plan or program, such a demonstration is generally considered as clear and convincing evidence of reasonable compensation.[249]

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245. Prop. Treas. Reg. § 1.280G-1, Q/A-9, 54 Fed. Reg. at 19,395.
246. *Id.*
247. *See* Kafka & Hoenicke, *supra* note 112, at A-22.
248. Prop. Treas. Reg. § 1.280G-1, Q/A-40, 54 Fed. Reg. at 19,406. Among the factors that are relevant to such a determination are:
    (a) The nature of the services rendered or to be rendered;
    (b) The individual's historic compensation for performing such services; and
    (c) The compensation of individuals performing comparable services in situations where the compensation is not contingent on a change in ownership or control.
    Id.
249. *Id.* § 1.280G-1, Q/A-41, 54 Fed. Reg. at 19,407; *see also id.* § 1.280G-1, Q/A-26(c), 54 Fed. Reg. at 19,401. The term "nondiscriminatory employee plan or program" means:
    a group term life insurance plan that meets the requirements of section 79(d); an employee benefit plan that meets the requirements of section 89(d) and (e); a self insured medical reimbursement plan that meets the requirements of section 105(h); a qualified group legal services plan (within the meaning of section 120); a cafeteria plan (within the meaning of section 125); an educational assistance program (within the meaning of section 127); and a dependent care assistance program (within the meaning of section 129).
    Id. § 1.280G-1, Q/A-26(c), 54 Fed. Reg. at 19,401.

2. Reasonable Compensation for Future Personal Services

Generally, clear and convincing evidence of reasonable compensation for future personal services may be shown if: (1) the individual receives payments for a period where there is actual performance of personal services; and (2) annual compensation is not significantly higher than annual compensation for the individual before the change (except for customary increases based upon greater responsibilities or cost of living adjustments).[250] The second part of this general rule affords an alternative test that can be satisfied if the annual compensation is not significantly higher than annual compensation normally paid by the employer or by comparable employers to persons performing comparable services.[251]

The general rule will not be met unless the individual actually performs services, except as provided in Q/A-42(b) of the proposed regulation. Q/A-42(b) covers situations where the disqualified individual is involuntarily terminated before the end of a contract term. In such a situation, a showing of the following five factors is generally considered clear and convincing evidence that the payment is reasonable compensation: (1) the contract was not entered into, amended, or renewed in contemplation of the change; (2) the compensation the individual would have received under the contract qualifies as reasonable compensation under section 162; (3) the damages do not exceed the present value of the compensation the individual would have received under the contract, if the individual had continued to perform services for the employer; (4) the disqualified individual offered to provide personal services but the offer was rejected by the employer; and (5) the damages are reduced by mitigation.[252]

There will be mitigation when the damages received by the disqualified individual are returned or reduced by "earned income," during the period the contract would have been in effect.[253] The Internal Revenue Service solicited comments on how mitigation of damages would be administered in other situations. Such situations include where the disqualified individual does not accept alternative employment during the remaining term of the contract or where the individual and corporation considered mitigation in arriving at the

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250. *See id.* § 1.280G-1, Q/A-42(a), 54 Fed. Reg. at 19,407.

251. *Id.*

252. *Id.* § 1.280G-1, Q/A-42(b), 54 Fed. Reg. at 19,407; *see also id.* § 1.280G-1, Q/A-42(c), 54 Fed. Reg. at 19,407 (illustrating the application of these factors).

253. *Id.* § 1.280G-1, Q/A-42(b), 54 Fed. Reg. at 19,407. The proposed regulation refers to § 911(d)(2)(A) for the definition of "earned income." That section defines earned income as any amount received as compensation for actual performance of personal services, but does not include any amount received as a distribution of earnings and profits. *See* I.R.C. § 911(d)(2)(A) (West Supp. 1991).

amount of a lump-sum settlement. State laws governing mitigation of damages may provide the administrative guidance.[254] If the employment agreement has an express mitigation or liquidated damages provision, such a provision should be respected without actual mitigation.[255]

3. Reasonable Compensation for Past Personal Services

There is also a general rule that payments for past personal services may be deemed reasonable compensation if they qualify as reasonable compensation under code section 162.[256] The legislative history provides that payments on account of past personal services will constitute reasonable compensation if they would have been paid in the future, even though the timing of the payments is caused by a change in ownership or control.[257] It should be noted, however, that Congress contemplated that "only in rare cases if any, will any portion of a parachute payment be treated as reasonable compensation in response to an argument that the executive was undercompensated in earlier years."[258]

4. Severance Payments

Severance payments and damages for failure to make severance payments are not considered reasonable compensation for past or future personal services.[259] One commentator observes, however, that severance payments normally made on termination of employment

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254. *See* AICPA, *supra* note 83, at 861.
255. *Id.*
256. *See* Prop. Treas. Reg. § 1.280G-1, Q/A-43(a), 54 Fed. Reg. at 19,407.
257. *See* H.R. REP. No. 861, 98th Cong., 2d Sess. 852-53 (1984). The relevant section of this House Report provides the following:

> For example: (1) payments in cancellation of a normal stock option, or normal stock appreciation right, granted more than one year before the change; (2) exercises after termination of stock options or stock appreciation rights issued as part of a normal compensation package granted more than one year before the change; (3) compensation previously earned and deferred pursuant to a plan of the employer, such as a staggered bonus plan, or at the election of the employee; and (4) amounts paid under a retirement plan that supplements a tax-qualified plan to the extent such amounts are designed to compensate a newly-hired key employee for the loss of retirement benefits attributable to services performed for a prior employer.

Id.; *see also* Kesner, *supra* note 195, at 269. Kesner recommends that the final regulation provide that certain widely used compensation arrangements include or constitute reasonable compensation. In addition, he suggests two examples that should be incorporated in the final regulations. *Id.*
258. H.R. REP. No. 861, 98th Cong., 2d Sess. 852 (1984).
259. Prop. Treas. Reg. § 1.280G-1, Q/A-44, 54 Fed. Reg. at 19,407.

under a plan not linked to a change in control should qualify as reasonable compensation for past personal services.[260] If this were the case, such severance payments would not be subject to excess parachute payment penalties. The commentator further states, in support of his position, that such severance payments "are made under reasonable and customary arrangements and that they are not subject to the abuses at which section 280G was aimed."[261]

J. Excess Parachute Payments

1. Computation of Excess Parachute Payments

The proposed regulation provides the rules for computing excess parachute payments and states that the amount of an excess parachute payment "is the excess of the amount of any parachute payment over the portion of the disqualified individual's base amount that is allocated to such payment."[262] The proposed regulation further provides that the portion of the base amount allocated to any parachute payment is "the amount that bears the same ratio to the base amount as the present value of such parachute payment bears to the aggregate present value of all parachute payments made to (or for the benefit of) the same disqualified individual."[263] Therefore, the part of the base amount[264] allocated to any parachute payment is computed by multiplying the base amount by a fraction, the numerator of which is the present value[265] of such parachute payment and the denominator of which is the total present value of all such payments.[266]

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260. *See* Sinaikin, *Severance Payments Prompted By Involuntary Termination Should Not Be Subject to Golden Parachute Rules*, 44 TAX NOTES 269 (1989).
261. *Id.* at 270.
262. Prop. Treas. Reg. § 1.280G-1, Q/A-38(a), 54 Fed. Reg. at 19,406.
263. *Id.*
264. *See id.* § 1.280G-1, Q/A-34, 54 Fed. Reg. at 19,404 (defining "base amount").
265. *See id.* § 1.280G-1, Q/A-31 to Q/A-33, 54 Fed. Reg. at 19,403-04 (rules on determining present value).
266. *See id.* § 1.280G-1, Q/A-38(a), 54 Fed. Reg. at 19,406. For example, suppose a disqualified individual with a base amount of $100,000 will receive two parachute payments, one of $300,000 and the other of $600,000. The $300,000 payment is made at the time of the change in ownership or control, and the $600,000 payment will be received on a future date. The present value of the $600,000 payment is $500,000 on the date of the change in ownership or control. The part of the base amount allocated to the first payment is $37,500 (($300,000/$800,000) x $100,000) and to the future payment is $62,500 (($500,000/$800,000) x $100,000). Therefore, the first excess parachute payment is $262,500 ($300,000 - $37,500) and the amount of the future excess parachute payment is $537,500 ($600,000 - $62,500). *Id.* § 1.280G-1, Q/A-38(b), 54 Fed. Reg. at 19,406.

2. Reduction of Excess Parachute Payments

Generally, an excess parachute payment may be reduced by any portion of the payment that the taxpayer demonstrates by clear and convincing evidence is reasonable compensation for past personal services performed by the disqualified individual.[267] The general rule, however, will not reduce securities violation parachute payments by reasonable compensation for past personal services.[268] Services reasonably compensated for by payments that are not parachute payments are not taken into account for purposes of this section.[269] When a taxpayer demonstrates reasonable compensation is a part of the parachute payment, reasonable compensation is first reduced by the portion of the base amount allocated to such parachute payment and any remaining part of the parachute payment demonstrated as reasonable compensation then reduces the excess parachute payment.[270]

K. Effective Date

Generally, the golden parachute regulations apply to payments under contracts executed or renewed after June 14, 1984.[271] Any contract that is executed before June 15, 1984 and renewed after June 14, 1984 is regarded as a new contract executed on the effective date of renewal.[272]

1. Contracts Cancellable at Will

A contract that may be terminated or cancelled unconditionally and at will by either party to the contract, or by both, is deemed a new contract executed on the date such termination or cancellation,

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267. *Id.* § 1.280G-1, Q/A-39(a), 54 Fed. Reg. at 19,406.
268. *Id.*
269. *Id.*
270. *Id.* For example, suppose a disqualified individual receives a parachute payment of $500,000 and the part of the individual's base amount that is allocated to the parachute payment is $100,000. Assume that $200,000 of the $500,000 parachute payment is demonstrated as reasonable compensation for past personal services. The amount of the excess parachute payment is determined to be $400,000 ($500,000 - $100,000) before the reasonable compensation is taken into account. In reducing the excess parachute payment by reasonable compensation, the part of the parachute payment that is demonstrated as reasonable compensation ($200,000) is first reduced by the part of the base amount allocated to the parachute payment ($100,000), and the remainder ($100,000) then reduces the excess parachute payment. Therefore, the excess parachute payment of $400,000 is reduced by $100,000 of reasonable compensation. *See id.* § 1.280G-1, Q/A-39(c) Example (1), 54 Fed. Reg. at 19,406.
271. *See id.* § 1.280G-1, Q/A-47, 54 Fed. Reg. at 19,408.
272. *Id.*

if made, would be effective.[273] A contract is not considered to be terminable or cancellable, however, if the termination or cancellation can be given effect only by terminating the employee or independent contractor relationship.[274]

2. Contracts Amended or Supplemented After June 14, 1984

If the contract is amended or supplemented in a significant manner after June 14, 1984, the golden parachute provisions apply to all payments under the contract, even payments made under agreements executed on or before June 14, 1984.[275] Accordingly, a contract amended in the above manner will lose its grandfathered status. A "supplement" to a contract is a new contract executed after June 14, 1984 that has an impact on the trigger, amount, or time of receipt of a payment under an existing contract.[276] If the parachute conditions are changed to provide significant additional benefits, a contract is treated as having been significantly amended or supplemented.[277] Q/A-50 of the proposed regulation provides that a contract will generally be treated as amended or supplemented in "significant relevant respect" if done: (1) "[t]o add or modify, to the disqualified individual's benefit, a change in ownership or control trigger," (2) "[t]o increase amounts payable that are contingent on a change in ownership or control, . . ." or (3) "[t]o accelerate, in the event of a change in ownership or control, the payment of amounts otherwise payable at a later date."[278]

For example, a corporation that amends a stock option to allow the individual to surrender it for cash or other property when the stock option is currently vested and exercisable, irrespective of whether a change in ownership or control occurs, is not regarded as amended in a significant relevant respect.[279] The underlying rationale is that the disqualified individual has not received significant additional benefits, because the individual could have exercised the option and sold the stock. Normal adjustments to the terms of employment or independent contract agreements will not be deemed to amend or supplement in a significant relevant respect.[280] A facts and circum-

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273. *Id.* § 1.280G-1, Q/A-48(a), 54 Fed. Reg. at 19,408.
274. *Id.*
275. *Id.* § 1.280G-1, Q/A-49, 54 Fed. Reg. at 19,408.
276. *Id.*
277. *Id.* § 1.280G-1, Q/A-50, 54 Fed. Reg. at 19,408.
278. *Id.*
279. *See id.* § 1.280G-1, Q/A-52 Example (1), 54 Fed. Reg. at 19,408-09.
280. *See id.* § 1.280G-1, Q/A-51, 54 Fed. Reg. at 19,408.

stances standard will be employed to determine whether an adjustment in the terms is normal.[281]

IV. CONCLUSION

Although Proposed Treasury Regulation section 1.280G-1 provides needed direction in determining when the harsh golden parachute penalties will be assessed, there are several issues that should be resolved in the final or temporary version of the regulation. This Article has shown that the proposed regulation has not clarified some important ambiguities and may even cause different tax results for similarly situated taxpayers. Furthermore, even though the Internal Revenue Service has indicated that the proposed regulation will provide guidance to taxpayers who must comply with section 280G, the Service should clarify in a notice whether taxpayers may rely on the proposed regulation.

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281. *Id.* The proposed regulation states that relevant factors include, but are not limited to, the following:

> (a) The length of time between the adjustment and the change in ownership or control;
> (b) The extent to which the corporation, at the time of adjustment, viewed itself as a likely takeover candidate;
> (c) A comparison of the adjustment with historical practices of the corporation;
> (d) The extent of the overlap between the group receiving the benefits of adjustment and those members of that group who are beneficiaries of pre-June 15, 1984, parachute contracts; and
> (e) The size of the adjustment, both in absolute terms and in comparison with the benefits provided to other members of the group receiving the benefits of the adjustment.

Id.