BEFORE CONSIDERING A SALE OF YOUR COMPANY, FIND OUT

- **The value of your payments and benefits upon a change in control,**
- **Whether your payments and benefits will trigger adverse consequences under Section 280G of the Internal Revenue Code, and**
- **How to avoid any adverse consequences through proper tax planning.**

As discussed in this presentation, we recommend that you have an illustration prepared showing your estimated payments and benefits upon a change in control based on when you believe a change in control may occur and a reasonable estimate of the acquisition price. The illustration would also show whether the value of your estimated change in control payments and benefits is likely to trigger adverse consequences under Section 280G of the Code and what steps may be taken to avoid those adverse consequences. There is never a bad time to have this change in control illustration prepared, but the best time to do so is before you start marketing your company and ideally at least one year before the change in control can be completed.

This presentation has been prepared by Jerry Heupel, a partner with Silver, Freedman, Taff & Tiernan LLP with over 25 years of experience with Section 280G of the Internal Revenue Code. The presentation is in an easy to read question and answer format. Jerry has handled the tax and benefits matters in numerous mergers, including the severance calculations and related tax planning to avoid the golden parachute excise taxes. His direct dial number is 202-295-4516, and he may also be reached at jerry@sfttlaw.com.

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1. **<u>What is Section 280G of the Internal Revenue Code</u>?**

Section 280G governs the treatment of golden parachute payments in the event of a change in control. In summary, if the parachute value of all of your payments and benefits equals or exceeds three times your "base amount," then you are subject to a 20% excise tax on the amount by which such value exceeds one times your base amount (the "excess parachute payment"), and your employer loses the ability to deduct the excess parachute payment.

It is important to note that if your total parachute payments equal or exceed three times your base amount (your "Section 280G Threshold"), the amount subject to a 20% excise tax is not just your parachute payments in excess of your Section 280G Threshold, but rather the entire amount of your parachute payments which exceed one times your base amount. For example, if an executive has a $300,000 base amount and receives parachute payments aggregating $1,050,000, his Section 280G Threshold is $899,999 and his excess parachute payments are $750,000 (i.e., $1,050,000 minus his base amount). The $750,000 excess parachute payment is subject to a 20% excise tax payable by the executive and is not deductible by the employer.

Additional illustrations are shown in Exhibit 1, including the effects of a Section 280G cut-back provision (where the executive's benefits are reduced) and a Section 280G gross-up provision (where the executive is reimbursed for the 20% excise tax and the additional taxes owed on the initial reimbursement).

2. **<u>What Is My Base Amount</u>?**

Your base amount is your average taxable compensation from your employer for the five calendar years preceding the year in which the change in control occurs. Generally, this is the average of your compensation shown in Box 1 of your Form W-2 for each of the five years. If you have been employed with your employer for less than the full five-year period, then the average is based on the length of time you have been with your employer, with the first year of compensation subject to certain annualization rules.

Because your base amount is fixed as of the end of the year preceding the year in which the change in control occurs, it is helpful to engage in tax planning before this occurs, as discussed in more detail below.

3. **<u>What Are Parachute Payments</u>?**

Parachute payments are any payments or benefits that are paid to you which meet all of the following conditions:

- The payment or benefit is compensation for services rendered,
- The payment or benefit is provided to a person covered by Section 280G of the Code,
- The payment or benefit is contingent on or related to a change in ownership, a change in effective control or a change in the ownership of a substantial portion of the employer's assets (a "change in control"), and
- When combined with other payments and benefits that satisfy the above three criteria, the payment or benefit equals at least three times the individual's base amount.

4. What Are Examples of Parachute Payments?

The following are examples of parachute payments:

- Cash severance,
- Bonuses paid in connection with the change in control (including stay bonuses and retention bonuses),
- The value of continued insurance coverage for you and your dependents, including but not limited to health, dental, vision, life and disability insurance premiums,
- Any cash payment you receive in lieu of continued insurance coverage,
- The value of all other fringe benefits continued for you, such as the use of an automobile, the payment of an automobile allowance, or the payment of club dues,
- Any cash payment you receive in lieu of continued fringe benefits,
- The accelerated vesting of stock options held by you,
- The accelerated vesting of restricted stock or other equity awards held by you,
- The waiver of performance criteria on any performance awards held by you,
- The accelerated vesting of benefits under a supplemental executive retirement plan (a "SERP"),
- Credit for additional years of service under SERPs or other benefit plans,
- Outplacement benefits,
- The accelerated payment of vested benefits,
- Stock options or other equity awards granted within one prior to the completion of the change in control, and
- Other increases in compensation (including increases in discretionary bonuses) within one year prior to the completion of a change in control, subject to certain exceptions.

5. Is the Full Value of Payments Subject to a Vesting Schedule Counted as a Parachute Payment?

If the payment or benefit is contingent only on the continued performance of services for a specified period of time, and the payment or benefit is at least partly attributable to services performed before the date the payment is made, then only a portion of the full value of the payment is deemed to be a parachute payment for purposes of Section 280G.

For stock options, restricted stock awards and other equity awards that have a fixed vesting schedule based solely on the passage of time, the full economic value of such awards is not deemed to be a parachute value. The portion that is treated as a parachute payment is based on a formula that takes into account the vesting schedule, the length of time that the vesting is accelerated, and IRS discount rates which change monthly. In addition, SERP benefits that are subject to a time-based vesting schedule are also covered by this special rule. However, performance-based equity awards are not covered by this special rule, as performance-based awards require specified goals or targets to be achieved before the award can vest.

It is important to note that equity awards which only vest upon the occurrence of a change in control do not qualify for this special rule. As a result, the full economic value of those awards is deemed to be a parachute payment.

6. How Are Payments That Will be Received in the Future Treated under Section 280G of the Code?

Payments and benefits that will be received at a date subsequent to the completion of the change in control are discounted to present value as of the effective date of the change in control. Generally, the discount rate used for this purpose is equal to 120% of the applicable federal rate published by the IRS each month, using the rates in effect for the month in which the change in control is completed.

7. Why Are Changes or Increases in Compensation Within One Year Prior to a Completion of a Change in Control Counted as a Parachute Payment?

The IRS regulations contain a presumption that any payment or benefit provided pursuant to a new agreement (or an amendment of an existing agreement), including an equity grant agreement, entered into within one year prior to completion of a change in control is related to or contingent on the change in control. This one-year presumption rule is the primary reason why the best time to engage in tax planning is at least one year prior to the completion of a change in control. (See Q. & A. 11 below.)

This one-year presumption rule frequently picks up new equity grants, increases in discretionary bonuses and other increases in compensation.

The one-year presumption can be rebutted if the employer and the affected individual are able to demonstrate by "clear and convincing evidence" that the new agreement or amendment was not related to or contingent on the change in control. This clear and convincing evidence requirement is a high burden of proof, but we have been able to successfully meet this standard in various instances.

8. What Types of Payments Are Not Treated as Parachute Payments?

The following are not considered parachute payments, even though you may receive a payment in connection with or as a result of a change in control:

- Vested stock options,
- Vested restricted stock awards and other vested equity awards,
- Vested SERP benefits,
- Any payments made to you under a tax-qualified retirement plan, such as a 401(k) plan or an Employee Stock Ownership Plan ("ESOP"), and
- For companies whose stock is not readily tradable on an established securities market, payments and benefits approved by shareholders (see Q. & A. 13 below).

While vested stock options, restricted stock awards and other equity grants are generally not treated as a parachute payment, these vested awards are still subject to the one-year presumption rule discussed in Q. & A. 7 above if the grant was made within one year prior to the completion of the change in control. If the equity award was granted more than one year prior to the change in control but a portion of the award vested during the one-year presumption period, neither the grant nor the vested amount is subject to the one-year presumption rule.

9. Who Is Covered by Section 280G of the Code?

Section 280G covers persons who fall within any of the following three categories:

- Officers of the company, subject to certain limits described below on the number of officers,
- Highly compensated individuals who are among the highest paid 1% of your total employees (rounded up to the nearest whole number), provided that the highest paid 1% cannot exceed 250 employees, and
- Shareholders who own more than 1% of the company's outstanding stock (NOTE: this provision can ensnare non-employee directors).

The maximum number of persons in the officer category depends upon your total number of employees. If you have 30 or fewer total employees, then the three highest paid officers are subject to Section 280G. If you have between 31 and 490 employees, then up to 10% of your total employees (rounded up to the nearest whole number) can be deemed officers for purposes of Section 280G. If you have 491 or more employees, then the maximum number of employees that can be deemed officers is 50.

A person is deemed to be a highly compensated individual if their compensation exceeds $115,000 in 2014. This amount is subject to adjustment on an annual basis.

We often find in smaller companies that one or more non-employee directors own more than 1% of the outstanding common stock. If these non-employee directors have unvested stock options or unvested restricted stock awards, or retirement agreements or other benefits that

provide for accelerated vesting upon a change in control, then the value of their change in control payments and benefits should also be reviewed.

10. What Is Involved with Tax Planning?

Our tax planning involves the following steps:

- First, we work with you to determine realistic assumptions as to the anticipated timing of a transaction and a likely acquisition price, and we frequently use multiple assumptions regarding both timing and price,
- We then review your agreements and benefit plans and gather all of the necessary compensation data required by such agreements and plans,
- We then prepare an illustration to show the expected value of your payments and benefits upon a change in control, and
- We also calculate your base amount and Section 280G threshold, and we illustrate for you how the parachute value of your payments and benefits compares to your Section 280G threshold.

After the above illustration is prepared, the next steps depend upon whether you are above your Section 280G threshold, the extent that you exceed your threshold, how close you are to a possible transaction, and the nature of your payments and benefits. Generally, tax planning in advance of marketing the company involves finding ways to increase your base amount by increasing your compensation or accelerating income into the five-year base period. Depending upon how your severance is calculated, some of the steps taken may also be designed to increase the severance paid to you upon completion of a change in control

11. When Is the Best Time to Do Tax Planning?

The best time to do tax planning is when you are at least one year away from the completion of a change in control. IRS regulations include a presumption that certain actions taken within one year of the completion of a change in control are presumed to be related to the change in control and are thus deemed to be a parachute payment. While this presumption can be rebutted, the burden of proof is on the company and the executive and requires clear and convincing evidence.

In addition, the closer you get to the change in control date, you begin to have fewer tax planning opportunities. For example, if you announce and complete a change in control in the same calendar year, then your base amount is already fixed at the time the transaction is announced. This reduces your tax planning opportunities. If you announce a transaction in one calendar year and do not close the transaction until the following calendar year, you still have the opportunity to increase your base amount (and your related Section 280G threshold) before the transaction closes.

12. My Company Shows Illustrative Payments in Our Annual Proxy Statements – Can I Just Rely on Those Numbers?

While those disclosures are helpful, we do not recommend relying on those disclosures to give you a true picture of your total change in control payments and benefits or the relation of such payments and benefits to your Section 280G threshold. You need to realize that the

numbers shown in the proxy statement are based on assumptions that a change in control occurred as of the last day of your most recent fiscal year-end and that the acquisition price was equal to the fair market value of your stock on such date. While these assumptions are required to be used by the Securities and Exchange Commission (the "SEC"), your actual payments and benefits (and your Section 280G threshold) are likely to differ materially from the numbers shown in the proxy statement.

As an example, for companies with a December 31 year-end, when you assume the change in control occurred on December 31, 2013, your base amount and Section 280G threshold is based on your average taxable compensation for the five years ended December 31, 2012, rather than the five years ended December 31, 2013. In addition, if a change in control is not likely to occur until 2015 or later, your actual Section 280G threshold in connection with the change in control will in all likelihood differ materially from the amount assumed in your most recent proxy statement. In addition, the proxy statement disclosures do not take into account vesting of equity awards or other benefits that will occur in the ordinary course between the end of the last fiscal year and a more realistic change in control date, and also do not take into account increases in compensation during such period.

Companies that are smaller reporting companies for SEC reporting purposes are not required to (and generally do not) show the amount of payments and benefits that would be paid in the event of a change in control in their regular annual meeting proxy statements, nor do companies which are not subject to the SEC disclosure requirements.

13. My Company Does Not File with the SEC – Do I Still Need to Worry About Section 280G?

Yes. Section 280G of the Code applies to both public and private companies. However, companies whose stock is not readily tradable on an established securities market can elect to obtain shareholder approval of the proposed change in control payments and benefits. If such payments are approved by at least 75% of the total outstanding shares eligible to vote (excluding shares held by the affected individuals), then the payments and benefits will not be subject to Section 280G. While we have used this exemption in the past, please note that this is a high vote requirement. In addition, in order to use this exemption, the right to obtain any payment or benefit that is submitted to shareholders for approval must be conditioned on the receipt of such shareholder approval.

Because of the high vote requirement to exempt change in control payments and benefits, and because the payment or benefit cannot be provided if shareholders do not approve the payment or benefit, we recommend that even private companies engage in tax planning to avoid the adverse consequences of Section 280G.

14. My Contract Has a Section 280G Gross-Up Provision – Do I Still Need to Worry About Section 280G?

Yes! This is especially true if your payments and benefits in a change in control will trigger the Section 280G gross-up provision. Absent proper tax planning to avoid the need for a gross-up, the employer will lose its corporate tax deduction and the acquirer will reduce the merger consideration it would otherwise pay to reflect the increased payment and the lost tax deduction. The payment of a Section 280G gross-up can become very expensive, as the initial reimbursement of the 20% excise tax is also deemed to be a parachute payment, and these gross-up provisions generally reimburse the executive for the additional federal and state income taxes, employment-related taxes and the additional 20% excise tax on the initial reimbursement. An example of how expensive a Section 280G gross-up provision can be is set forth in Exhibit 1.

We view Section 280G gross-up provisions as an incentive for a prospective acquirer to engage in proper tax planning with you and your employer to avoid triggering the gross-up payment, while at the same time providing you with the full economic value of your severance payments and other benefits.

15. My Contract Has a Section 280G Cut-Back Provision – Do I Still Need to Worry About Section 280G?

Yes. A Section 280G cut-back provision means that if the parachute value of your change in control payments and benefits exceeds your Section 280G threshold, then your payments and benefits are reduced so that no excise taxes are payable and the company does not lose its corporate tax deduction. However, this means that you do not receive the full value of all of the payments and benefits that you would otherwise be entitled to receive absent Section 280G. In addition, a prospective acquirer has less incentive to work with you in order to avoid the reduction in your payments and benefits than if you had a Section 280G gross-up provision. In order to ensure that you receive the full value of your payments and benefits, we recommend that you have a Section 280G illustration prepared and then engage in appropriate tax planning to avoid a reduction in your payments and benefits.

Disclaimer under IRS Circular 230 Disclosure:

As required by U.S. Treasury Regulations, we advise you that any tax advice contained in this communication (including the exhibit) is not intended to be used, and cannot be used, for the purpose of avoiding penalties under the Internal Revenue Code. These materials are provided for informational purposes only.

Exhibit 1

ILLUSTRATIVE CALCULATIONS (Abbreviated)

The following are illustrative calculations in abbreviated form, as the illustrations we generally prepare are in much more detail with supporting schedules. In addition, the illustrations below show the effect of a Section 280G cut-back provision and a Section 280G gross-up provision on the same set of facts, whereas an individual would only have one type of 280G provision applicable to him or her.

Type of Parachute	Amount
Cash severance	$ 900,000
Insurance benefits	45,000
Other fringe benefits	15,000
Unvested stock options	30,000
Unvested restricted stock	60,000
Total	1,050,000
Section 280G Threshold	899,999
Excess over 280G Threshold	$ 150,001

If the above executive is subject to a Section 280G cut-back provision, the executive's above parachute payments and benefits would be reduced by $150,001. Because the parachute value associated with unvested stock options and restricted stock awards is generally less than the full economic value of such awards, the executive would generally receive the value of his equity awards and have his cash severance reduced. Through proper tax planning, however, the executive could avoid the reduction and receive the full value of all of his payments and benefits.

If the executive has the benefit of a Section 280G gross-up provision, the company would reimburse him for the 20% excise taxes owed on $750,000 (i.e., $1,050,000 parachute payments minus $300,000 base amount), with the initial excise tax amounting to $150,000. This initial $150,000 reimbursement is deemed to be an additional parachute payment and is subject to federal and state income taxes and other employment-related taxes. A full gross-up provision is designed to place the executive in the same after-tax position he would have been in if the excise taxes had not been triggered. Assuming a 39.6% marginal federal income tax rate, a 5.0% state income tax rate and a 2.35% Medicare tax (1.45% plus 0.9%), the gross-up on the initial reimbursement would be an additional $278,204, resulting in a total gross-up payment to the executive of $428,004. Because the total cost of the Section 280G gross-up exceeds the amount by which the executive exceeds his Section 280G Threshold (even before taking into account the value of the lost corporate tax deduction), an increasing number of companies no longer provide Section 280G gross-up provisions. However, as previously noted, we believe these provisions encourage prospective acquirers to engage in tax planning to avoid the gross-up from being triggered, while at the same time ensuring the executive receives the full economic value of his change in control payments and benefits. We have avoided gross-up provisions from being triggered in situations where the dollar amounts involved substantially exceed those shown in the above example.