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M E M O R A N D U M

TO: **Our Clients and Friends**

FROM: **Silver, Freedman & Taff, L.L.P.**

DATE: **March 5, 2007**

RE: **Calculating Parachute Payments Under Section 280G**

The amount of the benefits payable in connection with a change in control is of prime importance. If change in control benefits reach certain levels, then without proper planning, the employer and the employee will be subject to adverse tax consequences.

Section 280G of the Internal Revenue Code of 1986, as amended (the "Code") imposes penalties on certain golden parachute payments. This Code provisions as well as the regulations applicable to golden parachutes are very complex. Due to the complexity of the law in this area, the discussion below is necessarily quite general.

The Code requires that the present value of all payments in the nature of compensation to an employee that are contingent on a change in control are added together to determine whether the employee is subject to a 20% penalty tax and the employer is subject to a loss of tax deductibility. Some examples of payments in the nature of compensation are severance payments and benefits, accelerated payment of long-term awards[1] and enhanced payments under supplemental retirement plans. (However, payments from qualified pension plans are specifically excluded.) A payment is considered contingent on a change in control if the employee's right to the payment, or the timing of the receipt of the payment, is contractually or factually contingent upon a change in control, but it is not necessary for the payment to be contingent on termination of employment. All payments under contracts or agreements entered into within one year of a change in control are presumed to be contingent on the change in control (even if by their terms they are not triggered by a change in control) unless this presumption is rebutted by clear and convincing evidence.

[1] Examples include accelerated vesting of benefits.

If the total amount of the change in control benefit to an employee equals or exceeds three times the employee's "base amount" (the average W-2 income of the employee for the five calendar years preceding the year in which the change in control occurs), the payments are considered "parachute payments," and the excess of the total amount of the parachute payments (not including certain reasonable compensation for personal services actually rendered before the change in control) over the base amount will be considered "excess parachute payments." Excess parachute payments are subject to a 20%, nondeductible penalty tax (payable by the employee but in most cases withheld and remitted by the employer) <u>and</u> are not deductible by the employer.

The table on the following page illustrates the effect of these tax consequences on the employee and the employer. For purposes of the table:

(i) the employee's base amount is assumed to be $100,000;

(ii) it is assumed that the amount of "reasonable compensation" for services actually rendered prior to the change in control does not exceed the base amount; and

(iii) Federal income tax rates of 35% (individual) and 35% (corporate) are applied.

To show the impact of exceeding the Code's parachute payment threshold, the table sets forth change in control payments equal to:

(a) one dollar less than three times the base amount (this amount is used to represent the maximum payment which does not trigger the excess parachute payment tax penalties);

(b) exactly three times the base amount; and

(c) the amount necessary on (b) to yield the employee an after-tax benefit equal to that provided by payment (a).

	(a)	(b)	(c)
Amount of Payment	$299,999	$300,000	$388,900
Average annual compensation (base amount)	$100,000	$100,000	$100,000
Limit test (299% x base amount)	$299,999	$299,999	$299,999
Excess parachute payment (subject to penalty tax and denial of deduction)	0	$200,000	$288,900
Employee individual federal income tax on amount of payment	$105,000	$105,000	$136,115
20% federal penalty tax	0	$ 40,000	$ 57,780
After tax (excluding parachute income tax, Medicare and FICA, if applicable)			
Cash to employee	$194,999	$155,000	$195,005
Cost to company	$194,999	$265,000	$353,900

As can be seen, a change in control payment of 388.9% of average compensation (payment (c) in the table above) provides exactly the same benefit to the employee as does a payment of 299% of average compensation (payment (a) in the table above) -- but costs the company 81.5% more after tax. Although payment (b) is one dollar greater than payment (a), on an after-tax basis, payment (b) yields the employee 21% less and costs the employer 36% more than does payment (a).

As a result of this tax treatment, an employment agreement which provides for a change in control benefit but does not take into account the tax consequences can be extremely costly to both the employer and the employee. Three alternative approaches may be utilized in an employment agreement to deal with the consequences of the golden parachute tax penalties:

(i) The amount of the change in control benefit under the employment agreement can be "grossed-up", so that if the penalty tax is triggered (and the corporate tax deduction lost) as to the "excess parachute payment," the employee is left with the same after-tax result as if there were no penalty tax (i.e., payment (c) in table above).

(ii) The change in control benefit under the employment agreement can be "capped" so that it will be paid or provided only to the extent that it, together with all other payments and benefits which are contingent on a change in control, does not exceed 299% of the base amount of compensation. The

penalty tax is therefore not triggered by this benefit and the employer's related tax deduction is preserved (assuming that other benefits contingent on a change in control outside the employment agreement do not exceed 299% of the base amount of compensation).

(iii) The change in control benefit under the employment agreement can be capped, but only if the result would be to give the employee a larger after-tax return than if the benefit were not capped.