Private Corporations and Section 280G of the Code

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This Note provides an overview of the shareholder approval exception under Section 280G of the Internal Revenue Code. Under this exception, the severe penalties of the golden parachute rules can be avoided for payments to disqualified individuals of privately held corporations in connection with a change in control if shareholder approval is obtained and certain disclosure requirements are met.

Section 280G and *Section 4999* of the Internal Revenue Code (IRC) (the Golden Parachute Rules) were enacted by Congress in 1984.

IRC Section 280G denies a tax deduction to corporations for parachute payments made to disqualified individuals that exceed a specified amount. In addition, IRC Section 4999 imposes a nondeductible 20% excise tax (which is in addition to regular income tax) on these payments (collectively, the Golden Parachute Penalties).

In general, parachute payments are compensation payments:

- Made to (or for the benefit of) disqualified individuals.
- Contingent on a change in control.
- In excess of a specified amount.

Disqualified individuals are employees or other service providers who are also either:

- Officers of the corporation.
- Highly compensated individuals.
- Significant shareholders of the corporation.

The Golden Parachute Penalties generally do not apply if a disqualified individual's parachute payments are less than the safe harbor amount of three times the individual's base amount (generally, the average annual taxable compensation for the five years preceding the year of the change in control). If the aggregate payments exceed the Section 280G safe harbor, then all amounts in excess of one times the individual's base amount are generally excess parachute payments subject to the Golden Parachute Penalties.

For an overview of the Golden Parachute Rules, see *Practice Note, Sections 280G and 4999 of the Code: Golden Parachute Payments (http://us.practicallaw.com/2-508-3188).*

THE PRIVATE COMPANY EXCEPTIONS

Although designed primarily for public companies, the Golden Parachute Rules and Golden Parachute Penalties can also apply to private corporations. However, a payment made to a disqualified individual by a private corporation may be exempt from treatment as a parachute payment (and therefore not subject to the Golden Parachute Penalties) if either of the following exceptions applies:

- **The Subchapter S exception**. The payment is made with regard to a corporation undergoing a change in control that is a "small business corporation" as defined in *IRC Section 1361(b)* and that is eligible to make an election to be treated as an S corporation (even if no election is in effect on the date of the change in control). *Final regulations* under IRC Section 280G extend the small business corporation definition to include a corporation that would qualify for S corporation status but for the restriction regarding nonresident alien shareholders. Foreign corporations, however, are not included in the definition and therefore cannot rely on this exception.
- **The Shareholder Approval exception**. The payment is made with regard to a privately held corporation and the payment is approved by shareholders under a vote that satisfies IRC Section 280G.

This Note describes the requirements that must be met to satisfy the shareholder approval exception for privately held corporations.

PRIVATELY HELD CORPORATION

For purposes of the shareholder approval exception, a privately held corporation is a corporation (other than a small business corporation) that immediately before the change in control has no stock readily tradable on an established securities market.

For purposes of this definition, members of an affiliated group are treated as a single corporation. Therefore, the exception does not apply if either:

- There is a publicly traded company in the affiliated group of the corporation undergoing the change in control.
- The corporation undergoing the change in control represents a substantial portion of a public entity's assets (that is, if the total fair market value of the stock of the corporation undergoing the change in control is equal to or exceeds one-third of the total gross fair market value of all of the assets of the public entity).

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SHAREHOLDER APPROVAL REQUIREMENTS

There are several shareholder approval requirements that must be met to qualify for the shareholder approval exception.

Percentage of Vote Required

IRC Section 280G requires the payment to be approved by persons who owned, immediately before the change in control, more than 75% of the voting power of all outstanding stock of the corporation undergoing the change in control.

If the individual receiving the payment is a shareholder, that person's shares (those held directly, and those shares constructively owned by the individual as determined under *IRC Section 318*) are disregarded in determining whether the voting threshold is met. An exception applies if all of the shares are held by disqualified individuals (see *Voting Restrictions*).

Voting Restrictions

Disqualified individuals receiving payments that would, but for the shareholder approval, be parachute payments may not vote, either on their own behalf or on behalf of an entity shareholder. Certain individuals related to these disqualified individuals (as determined under *IRC Section 318*) also may not vote.

Each disqualified individual who is a shareholder may not vote for payments made to himself or to other disqualified individuals. The same rule applies to related parties.

> Example
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> Five individuals own a corporation: A, B, C, D and E. A and B are entitled to parachute payments and C is related to A. D and E are the only shareholders eligible to vote. Even if the shareholders are voting separately on the payments to each of A and B, B cannot vote on the payments to be made to A. Likewise, A and C cannot vote on the payments to be made to B.

If all voting shareholders of the corporation undergoing the change in control are either disqualified individuals receiving payments or related persons, then the above voting restrictions do not apply and those individuals who would otherwise be excluded can participate in the shareholder vote.

An individual who holds vested or unvested stock options is not permitted to vote the shares underlying the individual's options.

When an entity owns shares of the corporation undergoing the change in control, the entity's vote must generally be made by a person authorized to vote on the entity's behalf (typically an officer). However, the vote approving the parachute payments must be made by persons who own more than 75% of the voting power of the entity shareholder if both:

- The stock comprises at least one-third of the entity shareholder's gross assets.
- The entity owns more than 1% of the total value of the corporation's stock.

> Practice Point
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> If the corporation undergoing the change in control represents less than one-third of the assets of any entity shareholder, consider including a recital stating this fact in the shareholder vote materials.

If the person authorized to vote on behalf of an entity shareholder is prohibited from voting, the entity shareholder may appoint a replacement.

Vote Must be Determinative

The shareholder approval must unequivocally determine the individual's right to receive or retain the parachute payment. For example, if a corporation agrees to grant transaction bonuses to certain disqualified individuals immediately before a change in control, the transaction bonuses must be contingent on obtaining the requisite 75% shareholder approval to qualify for the shareholder approval exception. If the bonuses will be paid even if shareholder approval is not obtained, the exception is not available.

It is permissible to obtain approval only for the portion of the payment that is in excess of the Section 280G safe harbor.

> Example
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> Shareholders are asked to approve a transaction bonus to a disqualified individual of $1 million. The disqualified individual's Section 280G safe harbor amount is $400,000. Some practitioners choose to subject the entire $1 million transaction bonus to the shareholder vote. In other cases, $600,000 is subject to the vote and the remaining $400,000 is paid, even if the shareholders do not approve any transaction bonus payment.

The exception is also not available if approval of the change in control itself is contingent on the approval of any payment to a disqualified individual that would, but for the exception, be a parachute payment.

> Practice Point
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> Because the approval of the transaction cannot be tied to the approval of the potential parachute payments, practitioners should consider drafting separate documents for purposes of voting on the transaction and approving the potential parachute payments. Practitioners should also avoid any provision in the transaction agreement that conditions the closing of the transaction on a favorable Section 280G vote approving the payment of the parachute payments. This may be interpreted as requiring a favorable Section 280G vote to close the deal. However, a transaction document may condition the closing of the deal on the absence of parachute payments.

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Often a disqualified individual has an existing right to parachute payments (for example, equity awards that vest on a change in control or severance amounts that are owed under an employment agreement entered into before the proposed change in control). In this case, if the payments exceed the Section 280G safe harbor amount, the shareholder approval exception is not available unless the individual waives any rights to the payments if shareholder approval is not obtained. The parties can then negotiate additional parachute payments that are contingent on obtaining the requisite shareholder approval.

If the individual waives the right to the payments and shareholder approval is not obtained, then the individual forfeits the right to the payments. Given the risks associated with submitting parachute payments to a shareholder vote, individuals are often reluctant (or unwilling) to waive their right to receive parachute payments. If an individual does agree to a waiver, the individual will likely insist that the waiver cover only the portion of the payments that are in excess of the Section 280G safe harbor.

If the individual does not waive the payments, then:

- The executive incurs the 20% excise tax under IRC Section 4999.
- The company is not entitled to deduct the payments.

Timing of the Vote and Shareholders Eligible to Vote

Under the exception, a payment must be approved by persons who owned, **immediately before the change in control,** more than 75% of the voting power of all outstanding stock of the corporation undergoing the change in control. While generally the vote is obtained just before the change in control, the final regulations provide that this requirement can be satisfied by choosing the shareholders of record as of any date within the six-month period immediately before the change in control. Therefore in certain cases the shareholders who are permitted to vote may not be the same as the shareholders at the time of the change in control.

Theoretically, it is possible to get a Section 280G vote before entering into a compensatory arrangement with a disqualified individual. However, because there are often subsequent changes in the company's shareholder base, these votes generally fail to qualify for the exception. Another complicating factor is that certain disclosures are required in connection with the vote (see *Adequate Disclosure*) and some of the information that must be disclosed is not available until shortly before a change in control occurs.

Form of Approval

The shareholders must approve the parachute payments in a separate vote (that is, a vote that is separate from the vote to approve the change in control). However, shareholders may approve parachute payments to a group of disqualified individuals either:

- In one vote.
- On an individual-by-individual basis.

Typically shareholders are asked to approve all parachute payments in one vote. However, the disclosure clarifies that they may approve all or only a portion of the parachute payments.

Shareholders may act by written consent, subject to any applicable state law prohibitions. (For example, certain states, such as Minnesota, Arizona and Texas, prohibit acting by written consent if the shareholder approval is not unanimous.)

ADEQUATE DISCLOSURE

For the exception to apply, the regulations require full and truthful disclosure of:

- All material facts concerning all payments that, but for the exception, would be parachute payments.
- Any additional information necessary to ensure that the disclosure is not materially misleading.

The disclosure must be made to every shareholder entitled to vote, not only those shareholders who hold 75% of the corporation's voting power. As lower level employees may own shares in connection with the exercise of stock options, they may receive sensitive compensation data because of this disclosure requirement.

Material facts that must be disclosed to shareholders include, but are not limited to:

- The event triggering the payment.
- The total amount of the payments that would be parachute payments but for the shareholder approval exemption (not just the amount of the payments subject to the shareholder vote).
- A brief description of each payment.

An omitted fact is considered material if there is a substantial likelihood that a reasonable shareholder would consider it important. For example, many practitioners believe that disclosure of material facts includes **all** compensation that the executive may receive in connection with the change in control, rather than only the parachute payments. These practitioners are of the view that shareholders cannot make an informed decision about whether to approve the payment without knowing the total amount that a disqualified individual will receive in connection with the transaction.

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