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Section 280G in the International Context

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Non-U.S. individuals and corporations should carefully evaluate how §280G applies to them when engaging in cross-border transactions, as there are a number of pitfalls that may not be apparent, says Joe Urwitz of Crowell & Moring.

The Internal Revenue Code of 1986, as amended (the "Code") imposes a 20% excise tax on compensatory payments made to a number of individuals under §280G of the Code and its regulations that are made pursuant to a corporate sale, and a loss of deduction on those amounts for the payor. Section 280G does not exclude either foreign individuals or corporations from coverage, meaning that non-U.S. taxpaying persons can become subject to the excise taxes and loss of deduction. The purpose of this article is to discuss some of the implications of foreign persons being subject to the tax and the obstacles companies and executives may face as a result.

Section 280G generally provides that when a "disqualified individual" receives "parachute payments," there is a loss of deduction for the company on any "excess parachute payment" that is paid, and §4999 of the Code imposes a 20% tax on the individual on the same amount. Section 280G defines "disqualified individual" as any individual who is (a) a 1% shareholder, (b) an officer and/or (c) in the most highly-compensated 1% of service providers of the company (Reg. §1.280G-1, Q&A 15). Section 280G defines "parachute payment" as a payment that: (a) is in the nature of compensation, (b) is made to or for the benefit of a disqualified individual, (c) is contingent on a change in ownership, effective control or assets of the corporation and (d) has, together with other parachute payments, a value in excess of three times the individual's base amount (as defined below) (Reg. §1.280G-1, Q&A 2). An "excess parachute payment" is the portion of any particular parachute payment above the portion of the "base amount" allocable to it (Reg. §1.280G-1, Q&A 3). For a U.S. taxpayer, "base amount" means the average annual compensation received by a disqualified individual in the five taxable years preceding a change in control which was includible in gross income (Reg. §1.280G-1, Q&A 34 and Q&A 35). For individuals, this will generally mean the five calendar years preceding a change in control.

For example, if a particular payment represented 40% of the total parachute payments being paid to a disqualified individual, §280G would impose a loss of deduction on the difference between (a) 40% of the disqualified individual's base amount, and (b) the amount of the payment. If a disqualified individual's base amount were $300,000 and she received $1,000,000 in parachute payments, of which $400,000 is payable as a transaction bonus on completion of the transaction, the company would lose a

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deduction on $280,000 (($400,000 – ($300,000 * .4)). If the company paid taxes at a 21% federal rate, the "cost" of that lost deduction to the company under §280G would be $58,800 ($280,000 * .21). Section 4999 would impose $56,000 in excise taxes on the disqualified individual ($280,000 * .2). A similar analysis would apply to other portions of the $1,000,000 parachute payment.

Fortunately for private companies, §280G contains a provision under which payments which would otherwise be parachute payments can be made to disqualified individuals without a loss of deduction under §280G or additional taxes under §4999 if, along with other requirements, more than 75% of the voting power of the company's stock approves the payment of such amounts. Functionally, the disqualified individual agrees to waive parachute payments to which he or she is otherwise entitled if the vote is not approved. In the example in the preceding paragraph, that would mean that the disqualified individual would either (a) forfeit his or her right to $100,000 (the portion of $1,000,000 in excess of three times the base amount of $300,000), if the shareholders did not approve the payment, or (b) be paid the full $1,000,000. In either case, neither the loss of deductibility under §280G nor the excise taxes under §4999 would apply.

Issue 1: U.S. Corp., Foreign Disqualified Individual

Where both the company and the disqualified individual are United States taxpayers, there's a clear alignment of interests: Both want a successful vote such that the company does not lose a deduction, and the disqualified individual does not owe excise taxes. As a technical matter, from a strictly economic perspective, the company might want a vote to fail so that it does not have to make payments above the three-times-base amount figure. However, rejecting payments to disqualified individuals which they would otherwise receive would likely be considered a show of extreme bad faith by future potential executives and investors in an industry and could severely impede the shareholders' ability to effectively invest in and manage future companies (in over 18 years of practice, the author has never worked on a transaction where payments above the three-times-base amount figure have failed). But where the company is a U.S. taxpayer and the disqualified individual is not, the calculus might change: A non-U.S. taxpayer might be reluctant to agree to waive parachute payments because he or she can receive those payments without having to pay excise taxes under §4999 without risking a "no" vote from shareholders. In the example above, the disqualified individual would receive the full $1,000,000 of parachute payments, but the company would lose a deduction on $700,000 of compensation ($1,000,000 - $300,000), which, at a 21% tax rate, is worth $147,000 ($700,000 * .21). This is a tax inefficiency: Had the disqualified individual agreed to waive payments, he or she likely would have either (a) received the full $1,000,000, assuming the vote passed, or (b) in the unlikely event of a failed vote, receive $100,000 less than he or she otherwise would have (i.e., the disqualified individual would receive $900,000, three times his or her base amount). Essentially, the company loses a tax deduction worth $147,000 so the disqualified individual does not run a small risk of not receiving $100,000.

A company might take one or more of several approaches to address this situation:

- The company could address the issue prior to entering into the arrangements paying parachute payments by including provisions in them that require the disqualified individual to subject the payments to a shareholder vote. In the author's experience, a greater number of companies are including such provisions in their arrangements.
- If the arrangements do not have such provisions in them at the time of a change in control, the company could either:

- Attempt to convince him or her to to expose payments to a vote by indicating that, while it cannot guarantee a "yes" vote, it does not have any reason to believe a vote would not pass (assuming that is correct); or
- Offer the disqualified individual an additional cash payment in exchange for exposing payments to a vote. That payment would itself be a parachute payment and would also need to be subject to a vote to avoid a loss of deduction under §280G.
  Because the disqualified individual will need to trust that the vote will pass, having a good working relationship with him or her is critical to getting the disqualified individual to agree to waive payments.

Issue 2: U.S. Disqualified Individual, Foreign Corp.

In the reverse situation, the disqualified individual is a U.S. taxpayer and the company is not. In that case, the disqualified individual will want to avoid paying the excise tax under §4999 but the company will not be concerned about the loss of deduction under §280G. This may lead the company to be less concerned about soliciting a vote, as the negative tax consequences of not conducting a vote will fall on the disqualified individual, rather than the company.

If the entity acquiring the corporation is not a U.S. taxpayer, it might not inquire about whether any executives are receiving parachute payments. If the disqualified individual has his or her own counsel in the transaction, that counsel might be attuned to the concern, but in the author's experience, executive counsel often are not. If neither the buyer, nor the seller, nor the disqualified individual is focused on conducting a vote to approve parachute payments, it likely will not occur. This has several implications:

- The disqualified individual will owe additional unexpected taxes on the payments, which may be substantial.
- Depending on the size and publicity of the transaction, both the corporation and the acquiring entity may get a negative reputation among executives, making it more difficult for their investors to entice U.S. employees to work for their future ventures.
- The corporation may fail to withhold taxes on the parachute payments, which is generally required unless an exception exists. Code §3402(a)(1) generally requires employers to withhold taxes from wage payments, and Code §4999(c)(1) requires withholding on excess parachute payments which are wages. There are a variety of exceptions to the withholding requirement under the Code, including where the disqualified individual's compensation is subject to foreign tax withholding (Code §3401(a)(8)(ii)). The full range of these exceptions is beyond the scope of this article.

If the entity acquiring the corporation is a U.S. taxpayer, it will likely have counsel who will be aware of the §4999 excise tax and will require the corporation to conduct an analysis as to whether any parachute payments will be made and, if so, to solicit a shareholder vote as a closing covenant in the relevant transaction document(s). Non-U.S. taxpaying entities with U.S. taxpaying disqualified individuals are advised to retain U.S. counsel to address the potential application of §280G.

Issue 3: Computing the Base Amount

As described above, the "base amount" for a U.S. taxpayer is the average annual compensation a disqualified individual receives for services rendered during the five taxable years immediately preceding the change in control which is includible in gross income. However, §280G specifically states that the base amount also includes amounts "which would have been includible in such gross income if such person had been a United States citizen or resident." (Reg. §1.280G-1, Q&A 34). This means that a U.S. company employing a disqualified individual who pays income taxes to a jurisdiction other than the U.S. cannot simply look at a foreign tax document reporting taxable compensation to determine the appropriate amount to use. This differs from U.S.-taxpaying disqualified individuals, where the amount reported in Box 1 of the U.S. federal Form W-2 is generally the amount used for determining how much compensation to add to the base amount for a particular year. Instead, to determine the precise amount, the company would need to make a determination of which amounts and benefits provided to the disqualified individual would be treated as taxable benefits to the disqualified individual. This can be a time-consuming endeavor, as the company would need to analyze not only the amounts reported as taxable to determine if any of them would not be includible in gross income if the person were a U.S. citizen or resident, but also other benefits that are not taxable in the foreign jurisdiction but might be in the United States.

Practitioners will often take a "don't let 'perfect' be the enemy of 'good'" approach to this issue. That is, they will initially use certain elements of compensation paid that are clearly includible in U.S. gross income, such as base salary and bonus compensation, in determining the base amount. This will likely cause the base amount to be artificially low, but including a low figure for the base amount would, all other things being equal, tend to result in *more* disqualified individuals, rather than fewer (as well as a larger parachute payment for the non-U.S. taxpaying individual(s)), and is therefore generally viewed as a conservative approach to determining whether any parachute payments will be made.

Section 280G requires that a private company soliciting a shareholder vote must provide shareholders "all material facts concerning all material payments" (Reg. §1.280G-1, Q&A 7). For a private company soliciting a shareholder vote, the author generally is comfortable that this requirement can be met without using all elements includible in gross income, as long as the disclosure clearly states, in a footnote or otherwise, which elements are the ones being included.

But there may be times where it makes sense to drill a little deeper to determine which aspects of foreign compensation would be includible if a person had been a U.S. citizen or resident. These include:

- Situations in which a private company is undergoing a change in control and three times the disqualified individual(s)' base amount(s), including just base salary and bonus payments, is barely under the amount needed such that no portion of the payments he or she receives in the transaction are parachute payments. In that case, if there are additional significant sources of compensation aside from base and bonus payments, it may be worth the effort to determine if there is enough compensation to increase the base amount to a point where there are no parachute payments to disclose.
- Situations in which a private company is undergoing a change in control and there is a strong desire to show shareholders that parachute payments are as limited as possible. This may occur for a number of reasons, including situations in which shareholders are other company employees or those rare situations in which a close vote is expected and the disqualified individual does not want to give the impression of receiving "too much" compensation in the change in control.
- Section 280G calculations for public companies where executives are projected to have parachute payments. Recall that a shareholder vote under §280G is only available if,

immediately before a change in control, none of its stock was readily tradeable on an established securities market (Reg. §1.280G-1, Q&A 6(a)(2)(i)). In that case, determining the full extent of the compensation payments to the non-U.S. taxpaying disqualified individuals which would be includible in U.S. gross income may reduce the amount of parachute payments and thus the company's lost deduction.

Conclusion

Section 280G presents numerous issues when only one of a company and disqualified individual are non-U.S. taxpayers. The three issues described above are ones the author has frequently encountered, but given the frequency of cross-border transactions, unlikely to be the only ones mergers and acquisitions attorneys are likely to encounter. Carefully evaluating a cross-border transaction in light of §280G is strongly recommended.

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