# GOLDEN PARACHUTE TAX PROVISIONS FALL FLAT: TAX GROSS-UPS SOFTEN THEIR IMPACT TO EXECUTIVES AND *SQUARE D* OVERINFLATES THEIR COVERAGE

Jamie Dietrich Hankinson*

## *HYPOTHETICAL*

Scott, the company's chief executive officer, is facing a dilemma. Scott's company is a merger target, and he is worried. He is not worried about whether his company's acquisition will be good for the company, because over the past several months he formed his opinion that the acquisition is in the shareholders' best interest. Scott's present concern is more personal.

Scott built this company. Over the past eighteen years, as the company grew rapidly, so did Scott's responsibilities. The company went public ten years ago, and shortly thereafter the board of directors appointed Scott as chief executive officer. Scott is proud of his company and proud of his accomplishments. Despite news of the pending acquisition, Scott continues to have a great working relationship with the entire executive management team and the company's employees.

Before Scott decided that the acquisition was in the best interests of the company and its shareholders, Scott battled all of the typical human feelings that arise during an acquisition. Scott loved his work at the company and could not imagine working

---

 Senior Associate, *Stetson Law Review*. B.A., Florida State University, 1982; B.S., University of Florida, 1984; M.Acc., University of Florida, 1985; J.D., Stetson University College of Law, 2004.

This Comment is dedicated to my husband, Barry, whose love and commonsense counsel has kept me happy and my life balanced during law school, and my sister, Tammy Evans, who consistently pushed me to achieve excellence. I thank Dean Teresa J. Pulley Radwan, Professors Janice Kay McClendon and Joseph F. Morrissey, and Brandon Waas for their suggestions that improved this Comment. I would also like to thank the *Stetson Law Review* advisors, associates, staff, and editors, particularly John Meffert, for preparing this Comment for publication. Finally, I thank Lesse Castleberry for inspiring me to go to law school.

anywhere else. Where would he go if the acquirer terminated his employment? Where would his company's employees work if the new management team terminated their employment? Scott's employees and his company were like his family. When Scott first announced that his company was the target of an acquisition, he could see the look of fear in his employees' eyes and in the eyes of his family members at home.

Over the past few months, as due diligence progressed, Scott met with key personnel from the acquirer. Scott was pleasantly surprised that the acquirer was not anticipating big changes in how the company operated; rather, the acquirer saw Scott's company as a well-run organization that needed only additional capital to grow. The acquirer could supply that additional capital.

Scott, like all of the other senior executives at the company, did not have to worry about his personal financial situation if he were to lose his job because of this acquisition. He had an employment contract providing for certain payments upon a change in control of the company followed by his resignation or involuntary termination by the acquirer. Scott designed his contract to protect himself financially if the company were sold and his position eliminated. This financial protection allowed Scott the peace of mind that he needed to evaluate the deal fairly, knowing that he would be financially secure even if he lost his job. Scott knew that the Internal Revenue Service would treat these contract payments as "golden parachute payments,"[1] and his company would pay all of his additional taxes on these payments. The payments would be large, several times his annual salary, and the additional cost to the company of paying Scott's taxes would be another large corporate expense. Scott realized that these contractual payments would be costly to the company. But he also knew that these arrangements were common, and he was relieved to have the agreement, not just for himself, but for the rest of the

1. A golden parachute payment is "[a]n employment-contract provision that grants an upper-level executive lucrative severance benefits—including long-term salary guarantees or bonuses—if control of the company changes hands (as by a merger)." *Black's Law Dictionary* 713 (Bryan A. Garner ed., 8th ed., West 2004). One of the most highly criticized golden parachute payments to date is that of Michael Ovitz, Walt Disney Company's former president, who received over $100 million when he was fired in 1996 after working only fourteen months. James Bates, *Ovitz's Disney Payout Revealed; The Fired Executive Reaped $109.3 Million But Failed to Exercise Stock Options Worth Potentially Even More*, L.A. Times C1 (May 20, 2004).

senior management team. Having these agreements in place allowed the entire senior management team to focus on the success of the company's acquisition.

But what if the acquirer decided not to terminate Scott after the acquisition? As Scott became more comfortable with the acquirer's plans, he began to wonder whether the acquirer might offer to retain him, rather than terminate his employment, after the acquisition. Scott knew that his expertise, history in the business, and great relationship with the company's employees would be very helpful to the acquirer. Would the acquirer recognize Scott's worth and offer him a new employment contract after the acquisition? Scott considered the contract terms he would negotiate after the acquisition if he were to stay, but he knew that any serious conversation about his future could not occur until later, after the acquirer had seen enough of Scott's work to recognize his worth to the future success of the new company.

As Scott pondered his future after the acquisition, Tom, the company's chief financial officer, interrupted his thoughts. Tom alerted Scott about a recent Tax Court decision in which executives retained following a corporate acquisition had surprisingly been subject to the same harsh "golden parachute" tax treatment on payments made by the acquirer for future services contracted *after* an acquisition. Scott understood that the "golden parachute" tax treatment applied to the employment agreement he entered into before the acquisition, but he also knew that, if payments were made under that agreement, he would be protected from the harsh tax treatment by his present employment agreement. But Scott did not know whether the acquirer would be so generous. What if, after the acquisition, the acquirer contracted to keep Scott employed at the new company, the Internal Revenue Service treated Scott like the executives in that Tax Court decision, and the new company chose not to protect him from the unexpected golden parachute tax impact? Then it would make no sense, from a personal financial standpoint, for Scott to stay with the company. Scott would have an incentive to leave the company, taking the sure thing—the golden parachute payments now—rather than dealing with the uncertainty of a possible harsh tax treatment later if he stayed with the company. If Scott instead took a job at another company after the acquisition, then he could avoid any risk from this uncertainty. Scott wondered why there was a tax law encouraging him to take the money and run, rather than staying with the company, which would be in the best interests of the acquirer, the company, and the company's shareholders.

## *I. INTRODUCTION*

With the increased frequency of mergers and acquisitions in the 1980s, Congress became concerned about abusively large payments made to executives when a corporation was acquired.[2] In response to this perceived abuse, Congress enacted a pair of tax statutes designed to reduce or eliminate these payments.[3] Sections 280G and 4999 of the Internal Revenue Code, both entitled "Golden parachute payments," are punitive tax provisions designed to discourage corporations from making, and executives from receiving, abusively large payments when a corporation is acquired.[4]

With § 280G, Congress attacked corporations by disallowing a corporate income tax deduction that was intended to discourage corporate golden parachute payments to executives.[5] With § 4999, Congress attacked executives receiving the golden parachute payments by imposing a new 20% excise tax that was intended to discourage the executive's receipt of these payments.[6] But this two-pronged attack on golden parachute payments has not worked as Congress intended.[7] In practice, corporations continue to make these payments, despite the payments being nondeductible, and executives continue to receive these payments, despite the excise tax imposed.[8] Furthermore, corporations use tax gross-

2. Bruce A. Wolk, *The Golden Parachute Provisions: Time for Repeal?* 21 Va. Tax Rev. 125, 126 (2001).

3. 26 U.S.C. §§ 280G, 4999 (2000).

4. *Id*.

5. Staff of Jt. Comm. on Taxn., *General Explanation of H.R. 4170*, 98th Cong. 199–201 (Dec. 31, 1984).

6. *Id.* at 200.

7. *See infra* nn. 86–107 and accompanying text (illustrating in Example 2 how Congress intended these two tax statutes to punish the corporation making golden parachute payments and the executives receiving golden parachute payments), and nn. 108–146 and accompanying text (illustrating in Examples 3 and 4 how executives, with the assistance of their employer corporations, can circumvent the punitive tax provision).

8. *See generally* Wolk, *supra* n. 2, at 134–142 (outlining three different ways that corporations structure employment contracts in response to §§ 280G and 4999).

ups[9] to transfer the punitive effects of § 4999 from the executive to the corporation.[10] Tax gross-ups eliminate the punitive effect on the executive by imposing even greater costs on the corporation.[11]

In addition to the problem of §§ 280G and 4999 not working as Congress intended, court interpretations have expanded the scope of transactions subject to the golden parachute provisions and thereby increased uncertainty.[12] In its most recent decision on the application of §§ 280G and 4999, *Square D Company v. Commissioner of Internal Revenue*,[13] the United States Tax Court in 2003 expanded the definition of golden parachute payments.[14] After *Square D*, the Tax Court will treat post-acquisition payments to executives as potentially subject to § 280G, despite the fact that the agreement concerning the payments is made *after* the change of control and therefore cannot be contingent on the change, as the statute requires.[15] *Square D* will encourage more executives, vital to the continued survival and success of the corporation, to eliminate uncertainty, pull the parachute rip cord, and leave the corporation with the parachute payment grossed up for the executives' taxes.[16] This result is not what Congress intended and is not in the best interests of the corporation or its shareholders.[17]

Part II of this Comment will define "golden parachute payments"[18] and discuss the legislative history behind Congress's enactment of §§ 280G and 4999 as well as the importance of the

---

9. Tax gross-ups are a mechanism whereby a corporation increases the amount of a payment to include the cost of the tax imposed on the recipient. *Id.* at 139–140.

10. *Id.*

11. *See infra* pt. III (illustrating the effects of tax gross-ups on the corporation and the executive).

12. *See infra* pt. IV (describing the courts' broadening application of §§ 280G and 4999).

13. 121 T.C. 168 (2003).

14. *See* Robert A. Rizzi, *New Case Heightens Impact of Golden Parachute Rules on Corporate M&A Practice*, 31 Corp. Tax 19 (2004) (discussing *Square D*'s harmful result of classifying more post-acquisition compensation of executives as subject to the golden parachute tax provisions). I credit this article for giving me the idea to write this Comment.

15. *See infra* pt. IV.D. (describing *Square D*'s expansion of the scope of § 280G to include post-acquisition agreements).

16. *Id.*

17. *Id.*

18. *See infra* pt. II.A. (distinguishing the common definition of "golden parachute payment" from the tax definition).

Treasury Regulations.[19] Part III will illustrate the application of §§ 280G and 4999 as Congress intended these statutes to work and how Congress's intention can be circumvented in practice.[20] Through a series of examples, this Part will illustrate how Congress intended to discourage golden parachute payments by comparing the tax treatment of corporate compensation payments to an executive with and without the application of §§ 280G and 4999.[21] Further, this Part will demonstrate how companies and executives can eliminate the harsh tax impact on the executive through tax gross-ups that increase the cost to the corporation.[22] Part IV will discuss court cases interpreting the definition of golden parachute payments and will focus on *Square D*'s surprising impact on executives and corporations following an acquisition.[23] This Part will also discuss the uncertainty caused by judicial expansion of the definition of golden parachute payments and how this uncertainty may cause executives to decide to take the golden parachute payment and leave the corporation, rather than staying with the corporation to help it succeed after an acquisition.[24] Finally, Part V will recommend the elimination of §§ 280G and 4999 because (1) these statutes do not work as Congress intended, (2) tax gross-ups exacerbate the corporate cost of these payments, and (3) judicial expansion of the definition of golden parachute payments unnecessarily increases uncertainty during a corporate acquisition.[25]

---

19. *See infra* pt. II.B. (describing the reasons why Congress enacted the golden parachute statutes); pt. II.C. (discussing the regulations defining when payments are contingent upon a change of control and the specific situation when payments are made under a post-acquisition agreement).

20. *See infra* pt. III (showing how Congress intended a two-pronged attack on the corporation and the executive and how corporations use tax gross-ups to circumvent Congress's intent).

21. *Id.*

22. *Id.*

23. *See infra* pt. IV (discussing *Square D* and court cases leading up to that decision).

24. *Id.*

25. *See infra* pt. V (suggesting legislative changes to golden parachute provisions).

## *II. HISTORICAL BACKGROUND*

### A. Statutory Tax Definition of "Golden Parachute Payment"

The phrase "golden parachute payment" has a different meaning in common business usage than in a tax context.[26] As commonly used, the term refers to large severance payments made when an executive's employment is terminated following a corporate acquisition.[27] However, for federal income tax purposes, the phrase, "golden parachute payment," has a definition that is keyed to a change in corporate control and is not limited to severance or other termination payments, but instead applies to *any payment* of compensation.[28] For tax purposes, a payment may be treated as a golden parachute payment even if the recipient does not involuntarily or voluntarily leave the corporation's employment.[29] In addition, the golden parachute tax provisions can apply to a corporation's 250 highest-paid employees, not only to a corporation's top executives.[30]

Other than in its title, § 280G does not use the term "golden parachute payments" but instead refers to these tainted payments as "excess" parachute payments.[31] Section 280G disallows a corporate income tax deduction for any "excess parachute payment,"[32] defined as the amount of the parachute payment in excess of a calculated base amount.[33] As used in this Comment,

26. *See* 26 U.S.C. § 280G(b)(2)(A) (defining "parachute payment" for tax purposes); Jay M. Zitter, *"Golden Parachute" Defense to Hostile Corporate Takeover*, 66 A.L.R.4th 138, 140 (1988) (defining "golden parachutes" as commonly used in business).

27. *See* Zitter, *supra* n. 26, at 140 (defining golden parachute agreements as "special termination agreements in order to forestall a hostile or unfriendly, unsolicited corporate takeover, whereby a corporation grants officers, directors, and executives substantial and lucrative payments that will be made if control of the corporation is taken over and they lose or leave their jobs thereby").

28. 26 U.S.C. § 280G(b)(2)(A).

29. *General Explanation of H.R. 4170*, 98th Cong. at 201.

30. 26 U.S.C. § 280G(c)(2). Section 280G applies to disqualified individuals including "highly-compensated individuals." *Id.* An employee is considered a "highly-compensated individual" if the employee is among the highest-paid 1% of employees or the highest-paid 250 employees, if 250 is less than 1% of all employees. *Id.*

31. *Id.* at § 280G(b).

32. *Id.* at § 280G(a).

33. *Id.* at § 280G(b)(1). The calculation of the base amount is complicated and beyond the scope of this Comment. However, the base amount is generally defined as the average annual compensation of the recipient over a recent period of time. *Id.* at § 280G(b)(3)(A).

golden parachute tax treatment means an excess parachute payment as defined in § 280G of the Internal Revenue Code.

For tax purposes, Congress defined a parachute payment as any payment of compensation[34] to a "disqualified individual"[35] that "is contingent on a change in the ownership or effective control of the corporation"[36] and equals or exceeds a calculated threshold amount based on the historical compensation of the executive.[37] Once a payment equals or exceeds the calculated threshold amount, § 280G applies, and all payments greater than the base amount are excess parachute payments.[38] Simply put, payments subject to golden parachute rules are those that the Internal Revenue Code deems excessively large in relation to the historical payments to the executive.[39]

The key to determining whether payments will be treated as golden parachute payments under §§ 280G and 4999 is to identify whether the payment is contingent on a change in ownership or control of the corporation, not whether the payment relates to the executive's loss of employment.[40] The process of identifying whether a payment is contingent on a change in ownership of the

---

34. Payments spread over a period of time or related to acceleration of stock option vesting require a present value calculation. *Id.* at § 280G(b)(2)(A)(ii).

35. *Id.* at § 280G(b)(2)(A). A "disqualified individual" is a person who provides personal services and "is an officer, shareholder, or highly-compensated individual." *Id.* at § 280G(c).

36. *Id.* at § 280G(b)(2)(A)(i). This part of the golden parachute definition is the focus of this Comment and is the part of the statute expanded by the Tax Court in *Square D*. 121 T.C. at 168.

37. 26 U.S.C. § 280G(b)(2)(A)(ii). In general terms, this calculated threshold amount is three times the calculated base amount, the executive's average annual compensation over a recent period of time. *Id.*

38. *Id.* at § 280G(b)(1). The following illustration explains the calculation of excess parachute payments. Assume that a corporation decides to pay an executive $4 million upon the corporation's change of control, when the executive's historical annual compensation averages $1 million. Because the $4 million exceeds three times the base amount of $1 million, the $3 million excess over the base amount ($4 million payment less $1 million base amount) will be treated as an excess parachute payment under §§ 280G and 4999. If the corporation instead decides to pay the executive just under the threshold amount of three times the base amount (or $2,999,999 here), then the payments will not be treated as excess parachute payments under §§ 280G and 4999. The Examples in Part III of this Comment focus on the "golden" part of the parachute payment, that in excess of the base amount, to calculate the tax effect on the corporation and recipient of a golden parachute payment.

39. 26 U.S.C. § 280G(b)(1).

40. *Id.* at § 280G(b)(2)(A).

corporation recently became much more complicated with the Tax Court's decision in *Square D*.[41]

## B. Legislative History

Courts interpreting golden parachute tax statutes have relied upon legislative history.[42] Congress enacted §§ 280G and 4999 as part of the Deficit Reduction Act of 1984.[43] The legislative history at the time of the laws' enactment provides evidence of the forces driving the legislation and the intent of the legislature.[44] The Senate stated its concern that corporations anticipating hostile takeover attempts entered into golden parachute agreements solely to benefit the corporation's executives.[45] Although the corporations purported to enter into the agreements as a defensive move to retain key personnel and to deter unfavorable acquisitions, the Senate was concerned that the golden parachutes really "assist[ed] an entrenched management team to remain in control" and "provide[d] corporate funds to subsidize officers or other highly compensated individuals."[46] The "subsidy" that the Senate opposed was the compensation deduction provided in § 162[47] for the payment of ordinary and necessary trade or business expenses.[48] The Senate believed that the payment of golden parachute payments was so egregious that a "tax penalty" should apply.[49]

The Staff of the Joint Committee on Taxation restated the reasons for the legislation.[50] First, as a policy matter, Congress wanted to discourage the use of golden parachute payments in hostile takeover situations when the payments served to deter potential buyers by either increasing the cost of the acquisition or

41. 121 T.C. at 168; *see infra* pt. IV.D. (discussing the Tax Court's expansion of § 280G's scope to include agreements entered into after a change of control).

42. *See infra* pt. IV (describing the courts' reliance on legislative history to determine whether payments were golden parachute payments).

43. Pub. L. No. 98-369, § 67(a), 98 Stat. 494, 585 (1984).

44. Sen. Fin. Comm. Rpt. 98–169 at 195 (Apr. 2, 1984).

45. *Id.*

46. *Id*.

47. 26 U.S.C. § 162(a).

48. Sen. Fin. Comm. Rpt. 98–169 at 195.

49. *Id.*

50. *General Explanation of H.R. 4170*, 98th Cong. at 199–200.

by discouraging interest in the target in the first place.[51] Second, Congress wanted to discourage the use of golden parachute payments in friendly takeover situations when they served to entice executives to favor a takeover solely because the executives stood to gain financially.[52] Finally, Congress wanted to discourage golden parachute payments in any takeover situation—hostile or friendly—because these payments theoretically reduced the amount that the target shareholders received in the acquisition.[53]

### C. Regulations

Five years after passing the golden parachute legislation, the Internal Revenue Service issued proposed regulations to implement § 280G in 1989.[54] The regulations are presented in question and answer ("Q&A") format and go into great technical detail about the treatment of golden parachute payments.[55] All of the cases discussing the application of § 280G through the publication date of this Comment rely upon the proposed regulations to some extent.[56] In 2002, the Internal Revenue Service issued new proposed regulations, which were finalized in 2003 and became effective in 2004.[57] The long period of time between the initial proposed regulations in 1989 and the new proposed regulations in 2002 led some tax practitioners to hope that the Internal Revenue Service had lost interest in golden parachute payments.[58] However, when the Internal Revenue Service finalized the regulations in 2003 with an effective date of 2004, this hope disappeared.[59]

These questions and answers help define those payments that are contingent on a change in ownership or control and are therefore subject to golden parachute tax treatment.[60] In particular, Q&A-22 discusses the general rule for determining whether payments are contingent on a change of control, and Q&A-23 dis-

51. *Id.* at 199.
52. *Id*. at 199–200.
53. *Id.* at 200.
54. Prop. Treas. Reg. § 1.280G–1, 54 Fed. Reg. 19390 (May 5, 1989).
55. *Id.* at 19393.
56. *Infra* pt. IV.
57. Rizzi, *supra* n. 14, at 22–23.
58. *Id.* at 22.
59. *Id.* at 22–23.
60. Prop. Treas. Reg. § 1.280G–1, 54 Fed. Reg. 19390, 19391.

cusses payments under agreements entered into after a change of control.[61] Q&A-22 tracks the language of the "standard," contained in the legislative history, for determining whether payments are contingent on a change of control.[62] A-22 defines the contingency as follows:

> [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 occurred. 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. (But see Q/A-23 of this section regarding payments under agreements entered into after a change in ownership or control.)[63]

Q&A-23 deals specifically with the situation of post-change-of-control agreements:

> Q-23: May a payment be treated as contingent on a change in ownership or control if the payment is made under an agreement entered into after the change?
>
> A-23: No. Payments are not treated as contingent on a change in ownership or control if they are made (or to be made) pursuant to an agreement entered into after the change. For this purpose, an agreement that is executed after a change in ownership or control, pursuant to a legally enforceable agreement that was entered into before the change, will be considered to have been entered into before the change.[64]

Practitioners had relied on the language of A-23 to conclude that only those post-change-of-control agreements that were "pursuant to a legally enforceable agreement that was entered into

61. *Id*. at 19398–19399.

62. *See* Staff of Jt. Comm. on Taxn., *supra* n. 5 (describing when a payment is treated as contingent on a change of control); Prop. Treas. Reg. § 1.280G–1, 54 Fed. Reg. 19390, 19398 (using almost the same language to convey the identical concept of when a payment is contingent on a change of control).

63. Prop. Treas. Reg. § 1.280G–1, 54 Fed. Reg. 19390, 19398.

64. *Id*. at 19399.

before the change" would be treated as subject to § 280G.[65] But *Square D* held that no pre-change legal obligation of the acquirer is necessary to subject future payments to § 280G.[66]

## *III. GOLDEN PARACHUTE PAYMENTS: IN THEORY AND IN PRACTICE*

This Part uses a series of Examples[67] to illustrate how Congress intended §§ 280G and 4999 to work to deter golden parachute payments. This Part also illustrates how corporations in practice can circumvent Congress's two-pronged attack on golden parachute payments through tax gross-ups.[68] First, Example 1 shows how the Internal Revenue Code taxes regular compensation not subject to §§ 280G and 4999.[69] Next, Example 2 shows how Congress intended a two-pronged attack on golden parachute payments under §§ 280G and 4999.[70] Finally, Examples 3 and 4 show how corporations merge the two-pronged attack into one borne entirely by the corporation through the use of tax gross-ups.[71] Specifically, Example 3 adds a tax gross-up for the executive's 20% excise tax under § 4999, and Example 4 adds a tax gross-up for the 20% excise tax under § 4999 and the executive's 35% individual income tax on the golden parachute payment.[72]

65. Rizzi, *supra* n. 14, at 21.

66. *Id.* at 22.

67. These Examples assume that the corporation is profitable and is subject to the top federal income tax rate of 35%. 26 U.S.C. § 11(b)(1)(D). Also, these Examples exclude the impact of social security and Medicare tax on the corporation and the executive. *Infra* pt. III (A)–(D). The Medicare tax rate is currently 1.45% of the compensation paid, imposed on the corporation and the executive. *Circular E, Employer's Tax Guide*, I.R.S. Pub. No. 15, at 2 (2004). The social security tax rate is currently 6.2% of compensation paid, imposed on the corporation and the executive, but limited to the first $87,900 in compensation in 2004. *Id*. Finally, these Examples exclude the effects of any state and local taxes on the corporation and the executive.

68. *See infra* nn. 108–146 and accompanying text (quantifying the expense of tax gross-ups).

69. *Infra* pt. III.A.

70. *Infra* pt. III.B.

71. *Infra* pt. III.C.–D.

72. *Id.*

### A. Example 1: Compensation Not Subject to §§ 280G and 4999[73]

Assume that a profitable corporation pays $3,000,000 in tax-deductible compensation to an executive, and the payment is not subject to §§ 280G or 4999. The corporation receives a corporate income tax deduction for the compensation payment.[74] Assuming a 35% corporate income tax rate,[75] the corporation receives a tax reduction of $1,050,000,[76] resulting in a net cost to the corporation of $1,950,000[77] for the payment of $3,000,000 in tax-deductible compensation to the executive. The $1,050,000 corporate income tax savings is the tax "subsidy" the Senate sought to eliminate in golden parachute situations.[78] When a corporation pays compensation that is deductible for federal income tax purposes, the corporation pays only $0.65 to give the executive $1.00 in compensation.[79]

The executive receiving the payment of this regular compensation must include the $3,000,000 receipt in his or her gross income.[80] Assuming a 35% individual income tax rate,[81] the executive pays $1,050,000[82] in individual income taxes,[83] resulting in a

73. This Example assumes that the compensation paid to the executive is not subject to the limitation on deductibility of non-performance-based executive compensation over $1 million. 26 U.S.C. § 162(m).

74. 26 U.S.C. § 162(a).

75. Corporations are subject to graduated tax rates that increase as annual taxable income increases. 26 U.S.C. § 11(b)(1)(A)–(D). Once corporate taxable income exceeds $10 million, the tax rate is 35%. *Id.* at § 11(b)(1)(D).

76. The corporate tax reduction of $1,050,000 is computed by multiplying the deductible compensation of $3,000,000 by the corporate tax rate of 35%.

77. The net cost to the corporation of $1,950,000 is computed by subtracting the $1,050,000 tax reduction from the $3,000,000 deductible compensation.

78. *See supra* nn. 42–53 and accompanying text (discussing the legislative history of §§ 280G and 4999).

79. The corporation pays $1,950,000 ($3,000,000 compensation paid to the executive net of the $1,050,000 corporate tax reduction)/$3,000,000 payment to the executive = $0.65.

80. 26 U.S.C. § 61 (2000).

81. Individuals are subject to graduated tax rates that increase as annual taxable income increases. 26 U.S.C. § 1 (2000). The tax bracket amounts are adjusted periodically for inflation. *Id.* at § 1(f)(1). For 2004, once individual taxable income exceeds $319,100 for an unmarried individual, the tax rate is 35%. Rev. Proc. 2003-85, 2003-49 I.R.B. 1184, 1186.

82. The executive's tax payment of $1,050,000 is computed by multiplying the taxable compensation of $3,000,000 by the individual income tax rate of 35%.

83. The fact that the tax rates for the corporation and the individual are the same in

net benefit to the executive of $1,950,000[84] after the executive's payment of individual income taxes. When the executive receives compensation that is not subject to § 4999, the executive keeps $0.65 of every $1.00 in compensation he or she receives.[85] The Internal Revenue Service serves as a conduit to transfer the $1,050,000 income tax the executive pays to the corporation through the corporate tax deduction.

### B. Example 2: Compensation Subject to §§ 280G and 4999: The Theory

Congress attacked golden parachute payments on two fronts– the corporation making the payment and the executive receiving the payment.[86] First, in § 280G, Congress disallowed a deduction for the corporation that paid the compensation.[87] Second, in § 4999, Congress imposed a 20% excise tax on the recipient of the compensation.[88] Congress enacted both of these punitive tax sections at the same time.[89] With this two-pronged attack—directed at the corporation making the payments and the executive receiving the payments—Congress intended to reduce the incentives of the corporate payer and the executive recipient, to discourage golden parachute payments altogether.[90] In theory, these two sections, working together, should reduce the desire of the corporation to make golden parachute payments at the same time that these sections lessen the desire of the executive to receive golden parachute payments.

---

these Examples reflects the current maximum tax rates on corporations and individuals in 2004. *Supra* nn. 75, 81. However, these maximum tax rates have not historically always been identical. For example, in 2000, the top marginal individual income tax rate was 39.6% while the top marginal corporate income tax rate was 35%. 26 U.S.C §§ 1, 11.

84. The net benefit to the executive of $1,950,000 is computed by subtracting the executive's $1,050,000 tax liability from the $3,000,000 taxable compensation.

85. The executive keeps $1,950,000 ($3,000,000 compensation paid to the executive net of the executive's $1,050,000 tax liability)/$3,000,000 payment to the executive = $0.65.

86. *See* 26 U.S.C. § 280G (disallowing a corporate deduction for golden parachute payments); 26 U.S.C. § 4999 (imposing a 20% tax on the recipient of a golden parachute payment).

87. *Id*. at § 280G.

88. *Id*. at § 4999(a).

89. Pub. L. No. 98-369, § 67(a), 98 Stat. 494, 585 (1984).

90. *General Explanation of H.R. 4170*, 98th Cong. at 200.

### *1. Punish the Corporation Making the Golden Parachute Payments: Loss of the Corporate Tax Deduction*

In theory, these provisions should deter corporations from making golden parachute payments because of their expense. Because the corporation cannot deduct the golden parachute payments under § 280G, golden parachute payments are more costly to the corporation than other compensation payments that are deductible under § 162.[91]

Assume that the $3,000,000 payment in Example 1[92] is subject to § 280G, and therefore the corporation cannot deduct the payment for federal income tax purposes. Under § 280G, the corporation loses the $1,050,000 benefit from the tax deduction.[93] Because the corporation has lost its tax subsidy, the $3,000,000 golden parachute payment to the executive costs the corporation $3,000,000.[94] When a corporation pays compensation that is not deductible for federal income tax purposes, the corporation pays $1.00 to give the executive $1.00 in compensation.[95] Compared to the $0.65 cost to the corporation to give the executive $1.00 in Example 1, a golden parachute payment costing $1.00 to give the executive $1.00 is 54% more expensive for the corporation.[96] Because golden parachute payments are more expensive to the corporation than other compensation payments, the corporation's desire to make golden parachute payments should be reduced.

### *2. Punish the Executive Receiving the Golden Parachute Payments: Imposition of the 20% Excise Tax*

In theory, these provisions should deter the executive from receiving golden parachute payments because of their expense. Because the executive must pay an additional 20% excise tax on the golden parachute payments under § 4999, golden parachute

91. *See infra* nn. 94–96 and accompanying text (calculating that a golden parachute payment is 54% more expensive to the corporation than a tax-deductible payment).

92. *Supra* nn. 73–85 and accompanying text.

93. *See supra* nn. 76–79 and accompanying text (calculating the corporate benefit from the corporate tax deduction).

94. The $3,000,000 cost to the corporation is computed by subtracting $0 tax reduction from the $3,000,000 payment.

95. The corporation pays $3,000,000 compensation to the executive with no tax deduction/$3,000,000 payment to the executive = $1.00.

96. ($1.00-$0.65)/$0.65 = .53846, rounded to 54%.

payments are more costly to the executive than other compensation receipts that are taxable as ordinary income received for services.[97] The excise tax is payable in addition to the individual income tax that the executive pays on the compensation received.[98]

Because the $3,000,000 payment is subject to § 280G in this Example, the payment is an excess parachute payment subject to the 20% additional tax under § 4999.[99] In addition to the $1,050,000 individual income tax the executive must pay on the $3,000,000 receipt,[100] the golden parachute payment triggers § 4999, requiring the executive to pay an additional excise tax of $600,000.[101] Because of the additional excise tax, the executive pays $1,650,000 in taxes to receive the $3,000,000 golden parachute payment.[102] The net benefit to the executive of the $3,000,000 golden parachute payment falls to $1,350,000 after the executive's payment of individual income tax and excise tax.[103] When the executive receives compensation that is subject to § 4999, the executive keeps only $0.45 of every $1.00 in compensation he or she receives.[104] Compared to the executive's $0.65 benefit for each $1.00 the executive received in Example 1, a golden parachute receipt of $1.00 is 44% more expensive to the executive.[105] Because golden parachute payments are more expensive to the executive than other compensation received, the executive's desire to receive golden parachute payments will be reduced. The Internal Revenue Service receives additional taxes

97. 26 U.S.C. § 4999.

98. *Id*. at § 1.

99. *Id*. at § 4999.

100. *See supra* n. 82 (calculating the individual income tax the executive must pay).

101. The executive's excise tax payment of $600,000 is computed by multiplying the golden parachute payment of $3,000,000 by the 20% excise tax rate under § 4999.

102. The executive's $1,650,000 tax payment is computed by adding the $1,050,000 individual income tax and the $600,000 excise tax under 4999.

103. The net benefit to the executive of $1,350,000 is computed by subtracting the $1,050,000 individual income tax and the $600,000 excise tax from the $3,000,000 payment.

104. The executive keeps $1,350,000 ($3,000,000 compensation paid to the executive net of the executive's $1,050,000 tax liability and the $600,000 excise tax)/$3,000,000 compensation paid to the executive = $0.45.

105. ($0.65-$0.45)/$0.45 = .44444, rounded to 44%.

of $1,050,000 from the corporation[106] and $600,000 from the executive.[107]

### C. Example 3: §§ 280G and 4999 in Practice: Gross-up for § 4999 Excise Tax

Theoretically, one might conclude that the loss of the corporate income tax deduction would be enough incentive for the corporation not to make golden parachute payments.[108] Example 2 shows that a golden parachute payment is 54% more expensive to the corporation than a tax-deductible payment because of the lost corporate income tax deduction.[109] However, corporations receive no tax deduction for other types of routine corporate payments including, for example, certain expenses for entertainment,[110] lobbying and political expenditures,[111] penalties,[112] and certain nonperformance based executive compensation over $1 million.[113]

But corporations commonly make nondeductible payments of executive compensation.[114] As reported at a recent hearing of the Senate Committee on Finance, "[i]t is often difficult for tax laws to have the desired effect on corporate behavior. Taxpayers may simply choose to incur the adverse tax consequences rather than change their behavior."[115] Although this particular statement re-

106. *See supra* nn. 76–79, 94–96, and accompanying text (calculating the additional tax paid by the corporation on a golden parachute payment).

107. *See supra* nn. 101–105 and accompanying text (calculating the additional tax paid by the executive on a golden parachute payment). This relatively modest Example 2 shows the potential tax windfall to the Treasury ($1,650,000 here). Yet, the Staff of the Joint Committee on Taxation estimated the impact of §§ 280G and 4999 at less than $5 million per year. *General Explanation of H.R. 4170*, 98th Cong. at 207.

108. *Supra* nn. 94–96 and accompanying text (showing that a golden parachute payment is more expensive to the corporation than a tax deductible compensation payment).

109. *Supra* nn. 94–96.

110. 26 U.S.C. § 274.

111. *Id*. at § 162(e).

112. *Id*. at § 162(f).

113. *Id*. at § 162(m).

114. *See* Jesse Drucker, *As CEOs Miss Bonus Goals, Goalposts Move*, Wall St. J. C1, C3 (July 7, 2004) (discussing how corporations change bonus targets, attempting to make executive compensation deductible; but if unsuccessful at making the executive payment tax deductible, the corporations opt to pay the non-deductible executive compensation and forego the corporate income tax deduction).

115. Sen. Fin. Comm., *Written Testimony of the Staff of the Joint Committee on Taxation on Executive Compensation and Company-Owned Life Insurance Arrangements of Enron Corporation and Related Entities*, 110th Cong. 30–31 (April 7, 2003).

lated to a different tax provision than §§ 280G and 4999 (the tax provision limiting the deductibility of non-performance based executive compensation over $1 million),[116] the Joint Committee on Taxation compared that tax provision to § 280G:

> Commentators generally observe that the golden parachute rules have done little to affect the amount of compensation payable upon a change of control. Rather, the rules are often thought of as providing a road map as to how to structure compensation arrangements. It is not uncommon for employment agreements to provide that, in the event the employee is subject to the excise tax, the tax will be paid by the company, with a gross up to reflect the income tax payable as a result of the employer's payment of the tax.[117]

As noted by the Joint Committee on Taxation in the quotation above, the two prongs of §§ 280G and 4999 do not work in practice as Congress intended.[118] This Example explains how these tax gross-ups work in practice.

### *1. Punish the Corporation Making the Golden Parachute Payment: Loss of the Corporate Tax Deduction and Gross-up for the Executive's Excise Tax*

As in Example 2, assume that the $3,000,000 payment is subject to § 280G, so the corporation loses its corporate income tax deduction.[119] In addition, assume that the corporation decides to pay the executive's excise tax, shifting the burden of the executive's 20% excise tax from the executive to the corporation through a tax gross-up procedure. First, the corporation pays the executive's $600,000 § 4999 excise tax.[120] Note that the corporation's payment of the employee's excise tax liability becomes additional taxable income to the executive, which results in an additional individual income tax and excise tax liability to the execu-

116. 26 U.S.C. § 162(m).
117. *Supra* n. 115, at 31 n. 44.
118. *Id.*
119. *Supra* n. 94 (calculating the cost to the corporation of the golden parachute payment).
120. *Supra* n. 101 (calculating the excise tax imposed on the executive receiving the golden parachute payment).

tive.[121] Because the corporation desires to shield the executive from all taxes resulting from the excise tax liability, the corporation also pays the executive's additional individual income tax and excise tax liability resulting from the corporation's payment of the executive's $600,000 excise tax liability. The corporation's payment of the executive's additional individual income tax and excise tax liability is also taxable income to the executive.[122] This process continues, with each successive round of the corporation's paying the executive's individual income tax creating additional individual income tax and excise tax liability for the executive.[123] Because of this iterative process, a formula is necessary to compute the ultimate corporate payment that will cover all of the executive's individual income taxes and excise taxes.[124] The formula is the following:

Net paid to executive/(1 – executive's tax rates) = Total payment[125]

For the corporation to pay the executive's $600,000 excise tax when that payment is taxable to the executive in the 35% individual income tax bracket, the corporation must pay a total of $1,333,333:

$600,000 tax/(1 – (20% + 35%)) = $1,333,333 total payment[126]

Through the tax gross-up process, the $600,000 excise tax imposed on the executive balloons to $1,333,333 when the corpo-

121. *Old Colony Trust Co. v. Commr.*, 279 U.S. 716, 729 (1929).

122. *Safe Harbor Water Power Corp. v. U.S.*, 303 F.2d 928, 933 (Ct. Cl. 1962).

123. *Id*.

124. Professor Bruce A. Wolk presents the gross-up calculation using a gross-up factor. The gross-up factor is multiplied by the excise tax amount, to arrive at the total payment. Wolk, *supra* n. 2, at 139–140. Professor Wolk's gross-up factor for the § 4999 excise tax is 1/(0.8 – t) where t is the executive's income tax rate. *Id.* at 140 n. 53. Professor Wolk's gross-up factor is analogous to the formula used in this Comment. To reconcile this Comment's formula with Professor Wolk's gross-up factor, note that the 20% excise tax rate has already been subtracted from the denominator of Professor Wolk's gross-up factor (0.8 – t). *Id*. The formula in this Comment shows the 20% excise tax explicitly in the denominator.

125. *Id.*

126. The calculation is validated by starting with the total payment and subtracting the additional excise tax and individual income tax to arrive at the $600,000 excise tax amount. Here, the $1,333,333 total payment, less $266,666 additional excise tax ($1,333,333 times 20% excise tax rate), less $466,667 individual income tax ($1,333,333 times 35% individual income tax rate), equals $600,000 excise tax on the $3,000,000 payment.

ration chooses to pay the executive's excise tax obligation. The total cost to the corporation of the $3,000,000 golden parachute payment increases to $5,850,000 when the payments are grossed-up for the executive's excise tax.[127] The excise tax gross-up costs the corporation $1.95 to give the executive $1.00 in compensation.[128] Compared to the corporation's golden parachute payment in Example 2 not grossed-up for the executive's excise taxes, which cost the corporation $1.00 for each $1.00 paid to the executive, Example 3's golden parachute payment grossed-up for the executive's excise tax is almost twice as expensive for the corporation.[129]

### *2. Protect the Executive Receiving the Golden Parachute Payment: The Corporation Pays the Executive's 20% Excise Tax*

Because the corporation fully protects the executive from excise tax liability on the golden parachute payment, by paying that excise tax and the additional income and excise tax on that payment, the executive with an excise tax gross-up is in the same position as the executive in Example 1, where the receipt of compensation is not subject to the golden parachute excise tax.[130] The executive receives $1,950,000 after taxes.[131] When the corporation pays the executive's grossed-up excise tax, the executive is no

127. The $5,850,000 corporate cost is calculated by adding the $3,000,000 initial golden parachute payment to the executive, the $1,333,333 payment to the Internal Revenue Service for the executive's grossed-up excise tax, and a $1,516,667 payment to the Internal Revenue Service because of the lost corporate income tax deduction on the $4,333,333 grossed-up golden parachute payment ($3,000,000 initial golden parachute payment plus the additional $1,333,333 gross-up payment for the excise tax) times the corporate income tax rate of 35%.

128. The corporation pays $5,850,000, including the cost of the excise tax gross-up/$3,000,000 payment to the executive = $1.95.

129. A nondeductible compensation payment costs the corporation $1.00 for each $1.00 paid to the executive. A golden parachute payment grossed-up for the executive's excise tax and associated income tax costs the corporation $1.95 for each $1.00 paid to the executive. The grossed-up golden parachute payment costs almost twice as much as the nondeductible golden parachute payment because $1.95 divided by $1.00 equals 1.95. Further, compared to the corporation's deductible payment of compensation in Example 1, which cost the corporation $0.65 for each $1.00 paid, Example 3's golden parachute payment grossed-up for the excise tax is three times as expensive because $1.95 divided by $0.65 equals 3.

130. *See supra* nn. 80–85 and accompanying text (computing the impact on the executive from receipt of compensation not subject to the golden parachute provisions).

131. *See supra* n. 84 (calculating the amount of the compensation the executive keeps when the payment is not subject to golden parachute rules).

longer discouraged from receiving golden parachute payments. Instead of the executive keeping only $0.45 of every dollar paid, when the executive is responsible for paying his or her excise tax on the golden parachute payment as in Example 2,[132] the executive keeps $0.65 of every dollar as in Example 1.[133] When the corporation grosses up the executive's golden parachute payment's excise tax, the § 4999 excise tax prong of the dual-pronged framework set up by Congress to discourage these golden parachute payments collapses. The Internal Revenue Service receives additional taxes of $1,516,667 from the corporation because of the lost corporate income tax deduction,[134] and $1,333,333 because of the corporation's payment of the executive's excise tax and additional individual income and excise taxes.[135]

### D. Example 4: Sections 280G and 4999 in Practice: Gross-up for § 4999 and the Executive's Individual Income Tax

Example 4 takes the tax gross-up procedure to its logical extreme, where the corporation grosses up not only for the executive's 20% excise tax under § 4999, but also for the executive's individual income tax on the golden parachute payment. Nothing in §§ 280G or 4999 precludes a corporation from also grossing up for the executive's individual income tax, although it is contrary to Congress's intent in enacting § 4999 because it encourages the executive to receive golden parachute payments over other compensation.

#### *1. Punish the Corporation Making the Golden Parachute Payment: Loss of the Corporate Tax Deduction and Gross-up for the Executive's Excise Tax and Individual Income Tax*

As in Examples 2 and 3, assume that the $3,000,000 payment is subject to § 280G so the corporation loses its corporate income

---

132. *See supra* n. 104 and accompanying text (calculating the part of the golden parachute payment the executive keeps when there is no gross-up for the executive's excise tax).

133. *Supra* n. 85 (calculating the part of the compensation the executive keeps when the golden parachute provisions do not apply).

134. *Supra* n. 127 (calculating the amount of tax paid by the corporation because of the lost corporate income tax deduction for the grossed-up golden parachute payment).

135. *See supra* n. 126 and accompanying text (calculating the corporation's grossed-up payment for the executive's excise tax).

tax deduction.[136] In addition, assume that the corporation decides to pay the executive's excise tax, as in Example 3, plus the executive's individual income tax through the tax gross-up procedure.

Using the gross-up formula from Example 3,[137] the corporation pays $6,666,666[138] to give the executive $3,000,000 and pays the executive's income and excise tax liabilities due on the executive's receipt of the golden parachute payment.[139] Including the impact of the lost corporate income tax deduction, the total cost to the corporation of the $3,000,000 golden parachute payment, when the payment is grossed up for the executive's excise and individual income taxes, increases to $9,000,000.[140] The excise tax and individual income tax gross-ups cost the corporation $3.00 to give the executive $1.00 in compensation.[141] Compared to a corporation's golden parachute payment in Example 3 grossed up for excise taxes only, which costs the corporation $1.95 for each $1.00 paid to the executive,[142] Example 4's golden parachute payment grossed up for the executive's excise and individual income taxes is one and one-half times as expensive to the corporation.[143]

---

136. *Supra* nn. 94, 119, and accompanying text.

137. *See supra* n. 125 and accompanying text (showing the tax gross-up formula).

138. The tax gross-up formula is the following:

Net paid to executive/(1 – executive's tax rates) = Total payment

Using this formula to gross-up the executive's $3,000,000 golden parachute payment for excise tax and individual income tax yields $6,666,666:

$3,000,000/(1 – (20% + 35%)) = $6,666,666

139. The calculation is validated by starting with the total payment and subtracting the additional excise tax and individual income tax to arrive at the $3,000,000 golden parachute payment. Here, the $6,666,666 total payment, less $1,333,333 additional excise tax ($6,666,666 times 20% excise tax rate), less $2,333,333 individual income tax ($6,666,666 times 35% individual income tax rate), equals $3,000,000 golden parachute payment.

140. The $9,000,000 corporate cost is calculated by adding the $3,000,000 initial golden parachute payment to the executive, the $1,333,333 payment to the Internal Revenue Service for the executive's grossed-up excise tax ($6,666,666 times the excise tax rate of 20%), the $2,333,333 payment to the Internal Revenue Service for the executive's grossed-up income tax ($6,666,666 times the individual income tax rate of 35%), and the $2,333,334 paid to the Internal Revenue Service because of the lost corporate income tax deduction ($6,666,666 times the corporate income tax rate of 35%).

141. The corporation pays $9,000,000 including the cost of the excise tax and individual income tax gross-ups/$3,000,000 payment to the executive = $3.00.

142. *Supra* n. 128.

143. A golden parachute payment grossed up for the executive's excise tax costs the corporation $1.95 for each $1.00 paid to the executive. A golden parachute payment grossed-up for all of the executive's taxes costs the corporation $3.00 for each $1.00 paid to the executive. The golden parachute payment grossed up for all of the executive's taxes

### *2. Protect the Executive Receiving the Golden Parachute Payment: The Corporation Pays the Executive's 20% Excise Tax and 35% Individual Income Tax*

Because the corporation fully protects the executive from the excise tax and individual income tax liabilities on the golden parachute payment, by paying these taxes for the executive, the executive with an excise and individual income tax gross-up is in the best possible position, keeping the entire $3,000,000 golden parachute payment. When the corporation pays the executive's excise and individual income taxes, the executive is no longer discouraged from receiving golden parachute payments. The executive will actually prefer golden parachute payments over other types of compensation when the corporation pays the executive's excise and individual income taxes on the payments. Instead of the executive keeping only $0.45 of every dollar paid when the executive is responsible for paying the excise tax on the golden parachute payment as in Example 2,[144] or keeping only $0.65 of every dollar paid when the executive is responsible for paying the individual income tax as in Example 1,[145] the executive keeps every dollar of the $3,000,000 golden parachute payment. The Internal Revenue Service receives additional taxes of $2,333,334 from the corporation because of the lost corporate income tax deduction and $3,666,666 because of the corporation's payment of the excise tax and associated individual income tax.[146] Because of the individual income tax gross-ups, the executive is in a better position than he or she would have been if the payment had not been a golden parachute payment.

## E. Sections 280G and 4999 Do Not Work as Congress Intended

Congress intended that both the corporation making the payments and the executive receiving them feel the punitive ef-

---

costs one and one-half times as much as the golden parachute payment grossed up only for the executive's excise tax because $3.00 divided by $1.95 equals approximately 1.5.

144. *See supra* n. 104 and accompanying text (calculating the after-tax cost to the executive of a golden parachute payment when the executive pays the excise and individual income taxes).

145. *See supra* n. 85 and accompanying text (calculating the after-tax cost to the executive of regular compensation when the executive pays the individual income tax).

146. *Supra* n. 140.

fects of golden parachute tax treatment.[147] Congress intended for the corporation to suffer the loss of a federal income tax deduction for the golden parachute payment and the executive to pay a 20% excise tax on the receipt.[148] This dual scheme was designed to encourage companies and executives to keep these payments under the threshold for golden parachute tax treatment.[149]

However, executives can contract with their employer corporation to pay the excise tax for them.[150] Tax gross-ups defeat Congress's two-pronged attack on golden parachute payments. When the corporation grosses up the executive's excise tax, § 4999 no longer discourages the executive from receiving a golden parachute payment. Further, executives can contract with their corporation to pay the excise and individual income taxes on the golden parachute payment. When the corporation pays the executive's excise and individual income taxes, the executive will prefer golden parachute payments over other compensation. Tax gross-ups are costly to the corporation and result in the corporation's paying more than the total taxes imposed if the corporation and executive had each paid their respective tax liabilities.

### F. The Shareholders Pay, without Knowing How Much

The corporation's shareholders pay for the tax gross-ups, but they may never know how much they pay because of poor disclosure requirements.[151] The acquirer will plan for the golden parachute payments and any tax gross-ups by making adjustments to the purchase price the acquirer pays the target corporation's shareholders for their shares of the corporation's stock.[152] But shareholders in publicly traded corporations are not informed

147. *See supra* nn. 86–107 (illustrating in Example 2 how Congress intended that §§ 280G and 4999, working together, would discourage the corporation from making these payments and the executive from receiving these payments).

148. *Id.*

149. *General Explanation of H.R. 4170*, 98th Cong. at 200.

150. Wolk, *supra* n. 2, at 139–141.

151. 17 C.F.R. § 229.402 (2004). Publicly traded corporations are required to disclose the amount of change-of-control payments to their most highly compensated executives, but no disclosure of the amount of tax gross-up payments is required. *Id.*

152. *General Explanation of H.R. 4170*, 98th Cong. at 200. Congress noted that an acquiring company will pay a maximum amount for the corporation and, to the extent that executives receive golden parachute payments, the shareholders of the target corporation receive less for their shares. *Id.*

about these purchase price negotiations between the acquirer and the target corporation's board of directors, so shareholders may never know the true impact of tax gross-ups. Although the shareholders can see the amounts of golden parachute payments in the proxy statement or prospectus disclosures, these payments exclude any tax gross-up amounts.[153]

In response to outcries for increased corporate accountability, Congress passed the Sarbanes-Oxley Act in 2002.[154] Congress's stated purpose in enacting this law was "[t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes."[155] Despite the addition of several enhanced financial disclosures, the Act did not add a requirement for disclosure of tax gross-ups for golden parachute payments.[156]

One of the new financial disclosures is a prohibition on corporations making personal loans to executives.[157] Despite the Act's apparent attempt to prevent conflicts of interest between an executive and an employer corporation,[158] the loan provision may actually result in more executives receiving tax gross-ups. Prior to the Sarbanes-Oxley Act's prohibition on personal loans, a corporation could make a loan to an executive to cover the executive's taxes on golden parachute payments.[159] These loans, when repaid, are less costly to a corporation than a tax gross-up because the executive pays his or her own taxes instead of the corporation's paying the executive's taxes. In its zeal to stop executives from using their employer corporations as low-interest banks, Congress may have inadvertently increased the occurrence of costly corporate tax gross-ups. With the new prohibition on corporate loans to executives, the corporation may now decide to gross-up the pay-

153. 17 C.F.R. § 229.402.

154. 15 U.S.C.A. § 7201 (West Supp. 2004).

155. Pub. L. No. 107-204, 116 Stat. 745, 745 (2002).

156. 15 U.S.C.A. § 7261.

157. *Id.* at § 78m(k).

158. Several months before the passage of the Sarbanes-Oxley Act, Bernard Ebbers resigned as chief executive officer of WorldCom. CNN/Money, *Ebbers out at WorldCom*, http://money.cnn.com/2002/04/30/technology/ebbers/ (accessed July 21, 2004). News that Bernard Ebbers owed his corporation $366 million in personal loans, amid accounting improprieties at the corporation, may have contributed to his forced resignation. *Id.*

159. *See id.* (reporting that WorldCom loaned money to its chief executive officer to enable him to increase the collateral on his personal line of credit).

ments and pay the executives' taxes for them, when in fact, arm's-length corporate loans to executives would be better for the corporation's shareholders.

## *IV. JUDICIAL EXPANSION OF §§ 280G AND 4999: MAKING A BAD SITUATION WORSE*

Only four cases examine the Internal Revenue Service's application of § 280G in a merger context, and each case is discussed below. The most recent case, *Square D*, is the most disturbing because it adds additional uncertainty to the tax treatment of retained executives' compensation after a corporate acquisition.[160] These cases show how courts have relied upon the legislative history and have interpreted regulations to expand the statutory scope of §§ 280G and 4999.

### A. *Cline v. Commissioner of Internal Revenue*[161]

In anticipation of his employer's acquisition, and believing that he had avoided the newly-enacted golden parachute provisions by one day, Cline entered into a severance agreement, triggered by a change of control on June 15, 1984.[162] Upon discovering that § 280G applied to agreements entered into on or after June 15, 1984, and that payments under his severance agreement were excess parachute payments, Cline amended his severance agreement to reduce his lump-sum payment to an amount that would come within § 280G's safe harbor.[163] The amended agreement also eliminated termination of Cline's employment as a prerequisite to payment.[164] At the time of the severance agreement's amendment and before the change in control, the acquirer orally promised Cline that it would "make a good faith effort" to employ him after the acquisition to make up for the reduced lump-sum payment in the amended agreement.[165] After the acquisition, the

160. *See infra* pt. IV.D. (discussing *Square D*).

161. 34 F.3d 480 (7th Cir. 1994).

162. *Id.* at 482.

163. *Id.* at 482–483. This type of provision, reducing an executive's payments under a change-of-control agreement to an amount just under the safe harbor, is referred to as a "capped contract." Wolk, *supra* n. 2, at 136–137.

164. *Cline*, 34 F.3d at 483.

165. *Id.*

acquirer paid Cline the lump-sum amount due to him under the amended agreement and continued his employment through a transitional period of several months.[166] Upon Cline's resignation, he received payment for his post-acquisition services plus a "bonus" to make up for the reduced payment under his amended agreement.[167] The Internal Revenue Service determined that the "bonus" was an excess parachute payment and that Cline was liable for the additional 20% excise tax.[168]

The Seventh Circuit Court of Appeals agreed with the Tax Court that "there was an agreement designed to camouflage a parachute payment."[169] The Tax Court viewed the lump-sum payment and the later "bonus" payment as made pursuant to two pre-change-of-control agreements.[170] The first agreement was the written lump-sum agreement, and the second agreement was the oral agreement for the "bonus" to make up for the reduced lump-sum payment.[171] On appeal, Cline first argued that the Tax Court had made a factual error because there was only one pre-change-of-control agreement, the written severance agreement, which was unrelated to the subsequent discretionary bonus payment.[172] Second, Cline argued that the Tax Court had made a legal error in determining that the bonus payment was a golden parachute payment because it was not made pursuant to a "*legally enforceable* agreement."[173]

The Seventh Circuit Court found adequate support in the record for the Tax Court's factual determination that a second oral agreement for the later bonus payment existed, given that the determination was based upon testimony of the acquirer and the acquired company that the acquirer intended to compensate Cline for the reduction in lump-sum payment.[174] Further, the court agreed with the Tax Court's holding that § 280G did not require a pre-acquisition, legally enforceable agreement for payment under

166. *Id*.
167. *Id.*
168. *Id.*
169. *Id.* at 485–486.
170. *Id*. at 484.
171. *Id*.
172. *Id*. at 484–485.
173. *Id*. at 486 (emphasis in original).
174. *Id*. at 485.

state law and that the acquiring corporation's pre-acquisition oral agreement to make a good faith effort to make up for reduced severance by future compensation was sufficient to invoke § 280G.[175]

In determining that § 280G did not require a legally enforceable agreement, the Seventh Circuit Court looked first to the language of the golden parachute statute, which applies to "*any* payment that is contingent on a change in ownership or control."[176] "[C]ontingent on a change in control" is not defined in the statute, so the Tax Court relied on the Conference Report, which uses a facts-and-circumstances analysis to determine if "the payment would not have been made had no change in control occurred."[177] The Tax Court also relied on Example (3) from the Deficit Reduction Act of 1984's General Explanation to conclude that a legally enforceable agreement or contract is not required for the court to find a payment was a golden parachute payment:

> Example (3). Assume that a disqualified individual is a common law employee of a corporation. A change in control of the corporation occurs, and, pursuant to a *formal or informal understanding* reached before the change occurs, the individual enters into an employment agreement, consulting agreement, agreement not to compete, or similar arrangement with the acquiring company for a term of 3 years. An amount equal to the value . . . of payments to be made under such an agreement is to be treated as contingent on the change in control.[178]

Although not discussed in *Cline*, the Example is also important because it illustrates the point in time when the agreement is made for purposes of triggering § 280G.[179] The agreements that are targeted for golden parachute treatment are those "reached *before* the change occurs."[180] The timing of the agreement or un-

175. *Id*. at 486–487.
176. *Id.* at 486.
177. *Id.*
178. *Id.* (quoting Staff of Jt. Comm. on Taxn., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, 98th Cong., 2d Sess. 201–202 (J. Comm. Print 1984) (emphasis added by the Tax Court).
179. *Id*.
180. *Id*. (emphasis added).

derstanding in *Cline* differs from that in *Square D*, which dealt with agreements made after the change of control occurred.[181]

### B. *Cvelbar v. CBI Illinois Inc.*[182]

This case is significant because it shows the court's approved use of statutory language, legislative history, and regulations to determine the application of § 280G. In *Cvelbar*, the Seventh Circuit Court of Appeals found that the determination by employer's counsel that severance payments to a former executive were golden parachute payments was reasonable when the counsel relied on the Internal Revenue Code, legislative history, and the proposed regulations.[183] Cvelbar's employment agreement provided severance benefits if his employer terminated him.[184] The agreement also specified that, if corporate counsel determined that any payment was subject to § 280G, then the corporation would reduce the payment to 299% of the executive's base amount, thereby avoiding golden parachute treatment.[185] After the corporation stopped making payments because corporate counsel determined that additional payments would exceed 299% of the terminated executive's base amount, Cvelbar filed suit to continue payment.[186] The Seventh Circuit Court affirmed the lower court's summary judgment motion for the corporation.[187] The court reasoned that the agreement gave corporate counsel the sole discretion to determine whether additional payments would be subject to § 280G and that corporate counsel did not make the decision arbitrarily or capriciously, but relied on the language of § 280G, its legislative history, the regulations, and a letter ruling in making the decision.[188]

181. *Infra* n. 196 and accompanying text.
182. 106 F.3d 1368 (7th Cir. 1997).
183. *Id.* at 1379–1380.
184. *Id.* at 1370.
185. *Id.* at 1371.
186. *Id.* at 1371–1372.
187. *Id.* at 1370.
188. *Id.* at 1379.

### C. *Hemingway v. United States* [189]

This case is important for setting the stage for *Square D*, because in *Square D* the acquirer, not the target corporation, made the payments alleged to be golden parachute payments. In *Hemingway*, the United States District Court of Utah found that parachute payments were not limited to payments made by the target corporation but extended to payments made by the acquiring corporation.[190] Hemingway was the chairman of two target corporations' boards of directors.[191] Prior to the merger, Hemingway entered into consulting agreements with the acquirer whereby the acquirer extended Hemingway's prior consulting contracts upon the consummation of the merger.[192] The Internal Revenue Service treated the acquirer's post-acquisition payments as golden parachute payments under §§ 280G and 4999 and denied Hemingway's motion for summary judgment.[193] The court reasoned that nothing in "the statute, the legislative history, [or] the regulations" indicated that § 280G applied only to payments made by the target upon a change in control.[194]

### D. *Square D Co. v. Commissioner of Internal Revenue*[195]

In *Square D*, the Tax Court concluded that § 280G applies to agreements made *after* a change of control when a pre-change-of-control agreement is the proximate cause of a post-change-of-control agreement.[196] But an agreement made after a change of control cannot be contingent upon the prior change of control, as required by the statute. Therefore, the post-change-of-control agreement in *Square D* does not fit within § 280G's definition of parachute payments.

---

189. 81 F. Supp. 2d 1163 (D. Utah 1999).
190. *Id.* at 1166.
191. *Id.* at 1163.
192. *Id.* at 1163–1164.
193. *Id.* at 1164, 1166.
194. *Id.* at 1165–1166.
195. 121 T.C. 168 (2003).
196. *Id*. at 210; *see* Rizzi, *supra* n. 14, at 22 (challenging the court's view that it was merely extending its approach in *Cline* by calling the *Square D* court's analysis a "novel approach").

In *Square D*, eighteen of the corporation's senior executives entered into employment agreements in 1990, in part because of heightened concerns of a hostile corporate takeover.[197] These agreements provided for lump-sum payments to the executives following a change of control if the executives were terminated without cause by the acquirer within three years or if the executives left their employment for "good reason."[198] "Good reason" was expanded to "*any* reason" for a thirty-day window after the one-year anniversary of the acquisition, thereby providing a window of opportunity for the executives to leave their employment and receive full payment under the 1990 agreements.[199] In 1991, Schneider S.A., a French company, acquired Square D for $2.25 billion and a change of control occurred.[200] Seven of these executives received their payments under the 1990 agreements, which were treated by the company as golden parachute payments under § 280G.[201] After the change of control, the other executives entered into new 1991 agreements that replaced the 1990 agreements.[202]

*Square D* considered the applicability of the golden parachute tax provisions to the new 1991 employment agreements, which were entered into after the change of control.[203] In finding that the 1991 agreements were subject to the application of §§ 280G and 4999, the court noted the "leverage" that the executives had over Schneider during the 1991 agreement negotiations.[204] Schneider knew that the success of its acquisition of Square D relied in significant part upon its ability to retain these key executives.[205] The court found that, in negotiating the 1991 agreements, Schneider's chairman of the board was motivated by his

197. 121 T.C. at 177.

198. *Id.* at 178. "Good reason" for the executives' leaving their employment included a reduction in responsibilities, a requirement to relocate, and nonpayment of compensation contained in the 1990 agreements. *Id.*

199. *Id.*

200. *Id.* at 172, 175. The thirty-day window of opportunity for executives to leave employment, therefore, started on May 30, 1992, and extended through June 28, 1992. *Id.* at 178.

201. *Id.* at 179. This fact is significant because it shows that Square D was not trying to avoid the application of § 280G in situations where it applied.

202. *Id.*

203. *Id.* at 203.

204. *Id.* at 180–181.

205. *Id.* at 180.

"fear[] that the 1990 Employment Agreements provided incentives for the executives to leave" the corporation during the thirty-day window following the anniversary of the acquisition.[206] Schneider wanted the revised agreements to provide incentives for the executives to remain employed beyond the thirty-day window ending in 1992.[207]

Tension arose in the negotiations between Schneider and the executives over the 1991 agreements because Schneider wanted an agreement "that would put 'most of the money *ahead* of [the executives] and not *behind* them,'" and the executives insisted upon no risk of future compensation but a guaranteed payment of the "golden parachutes" in the 1990 agreements.[208] Because of Schneider's insistence that the payments be forward-looking, rather than retroactive, Schneider refused to accept the executives' suggestion that Schneider cash out the "golden parachutes" in the 1990 agreements as a prerequisite to the 1991 agreements.[209]

Schneider's decision not to cash out the golden parachute payments appears to be based on its desire to keep the executives rather than on an attempt to avoid the imposition of § 280G. Schneider determined that paying out the 1990 "golden parachutes" would not help it meet its goal of retaining the executives because those payments would not give the executives an incentive to stay employed after the payment.[210] Schneider demonstrated that it was not attempting to evade the imposition of § 280G by treating all of the payments made to the seven executives who terminated their employment under the 1990 agreements as being subject to golden parachute treatment.[211]

The 1991 agreements extended employment of the executives through December 31, 1994, and provided for certain "without cause" termination payments prior to that date or if the executive

206. *Id.*
207. *Id.*
208. *Id.* at 181 (emphasis in original).
209. *Id.*
210. *Id.* at 180–182.
211. *Id.* at 179. In addition, in 1991, when various stock-related payments to the executives vested upon the change of control, Schneider treated these payments as subject to § 4999 and paid the executives additional compensation to cover the 20% tax imposed on those payments. *Id.* at 192.

left the corporation for "good reason."[212] The 1991 agreements provided additional compensation over that provided in the 1990 agreements and also provided for a "Retention Payment."[213] For all of the executives, the minimum Retention Payment under the 1991 agreement was greater than the "golden parachute" payment under the 1990 agreement.[214]

In 1992, Schneider and the executives amended the 1991 agreement to extend the employment term through December 1995 and to accelerate payment of the Retention Payment from February 1995 to December 1992.[215] Schneider decided to accelerate the Retention Payment because of tax law changes increasing individual income tax rates after 1992 and denying corporate income tax deductions for annual compensation in excess of $1 million.[216]

The golden parachute issue in *Square D* is whether the Retention Payments were "contingent on a change in the ownership or effective control of the corporation" under § 280G.[217] Because the statute does not explicitly define what is meant by this phrase, the court in *Square D* relied upon language in the legislative history, the regulations, and *Cline*'s analysis for its "standard" that "a payment is to be treated as contingent on a change of ownership or control . . . if such payment would not in fact have been made to the disqualified individual had no change in ownership or control occurred."[218]

The legislative history provides some definition of the required contingency:

> In general, a payment is to be treated as contingent on a change in ownership or control if such payment would not in

212. *Id.* at 183–184. "Good reason" was redefined to exclude "*any* reason" during a certain period of time as contained in the 1990 agreement. *Id.* at 184 (emphasis in original).

213. *Id.* at 183.

214. *Id*. at 185 (containing a table comparing the amounts due each executive for Termination Award payable under the 1990 agreements and Retention Payment under the 1991 employment agreement).

215. *Id.*

216. *Id.* (referring to the new tax statute in 26 U.S.C. § 162(m)).

217. *Id.* at 204. In addition to the Retention Payments, the golden parachute issue included certain supplemental retirement plan benefits. *Id.* at 204.

218. *Id.* at 204–211 (quoting H.R. Rpt. 98-861 at 851 (June 23, 1984), and *Cline v. Commr.*, 34 F.3d 480, 486 (7th Cir. 1994)).

> fact have been made had no change in ownership or control occurred. A payment generally is to be treated as one which would not have in fact been made unless it is substantially certain, at the time of the change, that the payment would have been made whether or not the change occurred. [219]

But the "standard" the Tax Court took from the legislative history will not work in cases in which executives continue to work for the acquirer after the acquisition. Under that "standard," an acquirer's payment will always be treated as contingent on a change of ownership or control because the acquirer (without the change of control) would make none of the post-acquisition payments. After the acquisition, all of the acquirer's payments would be treated as contingent on a change of ownership or control because the payments would not in fact have been made if the acquisition had never occurred. Because this "standard" does nothing more than state that all payments made by the acquirer are presumptively subject to § 280G, it is not really a standard at all.

The regulations interpreting this phrase exclude payments made "pursuant to an agreement entered into after the change," but consider payments made under post-change agreements entered into "pursuant to a legally enforceable agreement that was entered into before the change" to be subject to § 280G.[220] The court reads Q&A-23 in the regulations[221] to mean that a post-change-of-control agreement can obtain golden parachute taint through a legally enforceable agreement entered into before the change.[222] The court reads "pursuant to" in Q&A-23 to refer to the agreements in a proximate-cause sense.[223]

> Thus, if a legally enforceable pre-control-change agreement is the proximate cause of provisions in an agreement entered into after the change in control, the latter agreement is treated as executed "pursuant to" the former within the

219. *General Explanation of H.R. 4170*, 98th Cong. at 201.

220. Prop. Treas. Reg. § 1.280G–1, Q&A-23, 54 Fed. Reg. 19399.

221. *See supra* n. 64 and accompanying text (quoting the language of Q&A-23).

222. *Square D*, 121 T.C. at 207–208.

223. *Id.* at 207. *Black's Law Dictionary* defines proximate cause first as "[a] cause that is legally sufficient to result in liability" and second, "[a] cause that directly produces an event and without which the event would not have occurred." *Black's Law Dictionary* 234 (Bryan A. Garner ed., 8th ed., West 2004).

> meaning of the proposed regulations. As a consequence, under the proposed regulations, the latter agreement is 'considered to have been entered into before the change.'[224]

The court's proximate cause analysis here is strained. The court determined that the 1990 employment agreements were the proximate cause of the 1991 agreements, but that determination is not supported by the facts of this case. Instead of the 1990 agreements inducing the 1991 agreements, in fact, the talents of the executives themselves actually caused Schneider to enter into the 1991 agreements as it did. The court discusses the "significant degree of leverage" the executives had over Schneider during their 1991 agreement negotiations.[225] Then the court determined that the 1990 agreements provided the leverage; but, in fact, it was the talents of the executives themselves that provided the leverage. But for the talents of the executives that made them so highly sought after, Schneider would not have made the 1991 agreements seeking to retain the executives' services.

The plain language of § 280G says that golden parachute tax treatment applies only to payments that are "contingent on a change in the ownership or effective control of the corporation."[226] The statute further provides that agreements entered into or amended within one year before the change of control are presumed contingent on the change, subject to rebuttal with clear and convincing evidence.[227] The statute does not provide that agreements entered into or amended after the change of control are presumed contingent on the change, but the Tax Court somehow reached that conclusion in *Square D*.[228] *Square D* expands the application of § 280G by finding that any legally enforceable pre-change parachute agreement taints post-change agreements for executives who stay with the corporation following the acquisition.[229]

224. *Square D*, 121 T.C. at 207.
225. *Id*.
226. 26 U.S.C. § 280G(b)(2)(A).
227. *Id.* at § 280G(b)(2)(C).
228. *Square D*, 121 T.C. at 207–208.
229. *Id*. at 210.

## *V. RECOMMENDATIONS*

The tax treatment of golden parachute payments is due for a change because the tax statutes do not work as Congress intended. The statutes harm shareholders through tax gross-ups and may hamper the acquiring corporation's efforts to retain executives important to the corporation's continued success. If executives are concerned that their post-acquisition compensation may be arbitrarily subjected to golden parachute tax treatment without contract protection from the harsh tax treatment by the new employer, then the executives may decide to eliminate uncertainty and leave the corporation with their golden parachute payments rather than stay with the new corporation. When executives who are vital to the continued success of the new corporation leave because of arbitrary tax treatment, then the only winners are the executives.

Ironically, Congress's concern that shareholders were receiving less money for their shares in mergers as a result of golden parachute payments has been exacerbated by §§ 280G and 4999 and tax gross-ups. Eliminating §§ 280G and 4999 would actually decrease the cost of mergers and increase the money paid to the target shareholders or acquirer's shareholders over time. However, if Congress intends to legislate corporate conduct through § 280G,[230] then, at a minimum, § 4999 should be repealed. Section 4999 is not effective in deterring executives from accepting golden parachute payments when the corporation pays the additional tax for the executive. When the corporation also grosses up for the executive's individual income tax on these payments, the total cost to the corporation increases.

## *VI. CONCLUSION*

The golden parachute tax provisions fall flat because they do not work as Congress intended. Through tax gross-ups, the corporation and executive can easily circumvent Congress's two-

230. Commentators question whether the tax code is the appropriate mechanism for implementing social policy. *See* Hurt Hartmann, *The Market for Corporate Confusion: Federal Attempts to Regulate the Market for Corporate Control through the Federal Tax Code*, 6 DePaul Bus. L. J. 159, 199 (1993) (arguing that the federal government should leave corporate protection issues to state legislators).

pronged attack on the corporation making the payments and the executive receiving the payments. Congress can rely only on the corporation to discourage these payments, and experience has shown that corporations still choose to make these payments and to incur the exorbitant costs of tax gross-ups for executives. Congress should eliminate §§ 280G and 4999 from the Internal Revenue Code because these sections do not work as Congress intended.

Eliminating the golden parachute tax provisions from the Internal Revenue Code would also solve the problem of judicial expansion of the scope of these provisions. Since these provisions were enacted, courts have expanded their scope to capture transactions entered into after an acquisition, paid by the acquirer, and without the requirement of a binding pre-acquisition agreement. Now, courts have the tough job of trying to determine whether target corporation executives exert sufficient leverage on the acquiring corporation to cause a post-acquisition payment. Congress should stop this strained judicial analysis of these transactions by eliminating the golden parachute tax provisions.