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Plan Before a Change in Control to Avoid Excess Golden Parachute Payments



Golden parachute payments often occur when a company undergoes a change in control.

In the case of a sale of a corporation or a sale of a substantial portion of a corporation's assets, certain key employees may receive so-called golden parachute payments, (i.e., payments that are contingent on the sale such as bonuses, vesting of equity compensation, severance, etc.). If the aggregate value of such payments equals or exceeds a threshold amount, then the employee is subject to a 20% excise tax on a portion of the golden parachute (not just the excess above the threshold amount) and the employer is not entitled to an income tax deduction for such excess. A pre-sale golden parachute payment study can assist the company in determining the extent to which the company has exposure to these rules. If there is exposure, there may be planning opportunities to reduce or eliminate negative tax results.

Golden Parachute Rules and Penalties

The golden parachute rules are detailed in Internal Revenue Code Secs. 280G and 4999. Excess parachute payments are defined under Sec. 280G as an amount equal to the excess over the base amount (Base Amount). Base Amount is defined as the individual's average annual taxable compensation for the base period. The base period is then defined as the most recent five years ending before the date of the change in ownership or control in which the individual was an employee or independent contractor. Golden parachute penalties do not apply if the parachute payments are less than three times the Base Amount (Safe Harbor). If the payments equal or exceed the Safe Harbor, the penalty is calculated on the total value of the payments in excess of the Base Amount. For example, if the Base Amount is \$100,000, then the individual cannot receive contingent payments of \$300,000 or more and avoid the excise tax. If the individual receives \$300,000 the penalty would be \$40,000 $((\$300,000 - \$100,000) \times 20\%)$. On the other hand, if the individual only receives \$299,999 there would be no penalty to the individual and the company could take the full amount as a deduction.

Pre-Sale Study to Reduce Excess Parachute Payments

A pre-sale golden parachute payments study can assist in determining the extent to which the company and the individual have exposure to these rules. Excess parachute payments can be reduced by demonstrating with clear and convincing evidence that a portion of the parachute payment is reasonable compensation for services performed before the change in control. For example, if the individual was underpaid relative to similar executives at peer companies in years prior to the change in control, the corporation could demonstrate that all or a portion of the payment is a catch-up payment.

Non-Competition Agreements and the Importance of Valuation

Parachute payments can also be reduced or eliminated by demonstrating that a portion of the payment is reasonable compensation for services to be performed after the change in control. For example, a non-competition agreement may restrict the individual's ability to compete with the company for a certain period of time after employment is terminated. Without the non-competition agreement in place, the company could experience an economic loss due to such competition. As a result, the value of a non-competition agreement can be an important factor in the determination of excess parachute payments.

In valuing the non-competition agreement, IRS valuation guidelines must be followed closely. In Rev. Rul. 77-403, IRS stated that in order to place value on a non-competition agreement, one must demonstrate that a person bound by a non-competition agreement (the Covenantor) would, under normal circumstances, have the ability, feasibility and desire to compete absent any explicit arrangement.

The courts have ruled that the ability of a Covenantor to compete is evidenced by the individual's experience in and knowledge of the transferred business. Specifically, such ability can be indicated by the Covenantor's thorough knowledge of the company's operations, markets and strategies. Ability is also evidenced by the Covenantor's leadership and stature in the industry and the community, as well as by his or her financial wherewithal and entrepreneurial ability.

The question of feasibility is normally associated with endogenous factors such as barriers to entry. Such barriers might include time to start a competing operation, procurement of necessary licenses, availability of labor and amount of capital investment required in light of returns expected.

The desire to compete can be demonstrated by showing that there are no factors, such as age and health of the Covenantor, or the attractiveness of the returns expected, that would diminish the desire to compete.

The method most often used to determine the value of a non-competition agreement is the discounted cash flow (DCF) analysis in the form of a *with-without method*. This method values a non-competition agreement by quantifying the economic harm that could occur to the business in the absence of the agreement. Generally, a probability adjusted DCF analysis is performed to determine the value of the business assuming expected cash flows with the non-competition agreement in place (the *with* scenario). This value is then compared to the indicated value of the business from the DCF assuming expected cash flows without the non-competition agreement in place (the *without* scenario). The difference represents the value of the non-compete agreement.

It is extremely important that the appraisal of the non-competition agreement follows IRS requirements. Further, it is critical that the assumptions used in both the *with* and the *without* scenarios are supported by sound and supportable assumptions. The valuation process includes interviews with company management as well as independent related research to quantify the parameters utilized to quantify the economic impact on the company if the Covenantor were to compete.

Plan Before a Change in Control Occurs

Golden parachute payments have the potential to yield significant tax consequences for both a company and the individual employees involved. Planning before a change in control or sale of a substantial portion of corporate assets can help mitigate the tax consequences by examining ways to reduce excess parachute payments and by strategically using non-competition agreements.



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Flying Private: A Common Business Expense?



As the cost, inconvenience and security concerns of commercial flights continue to grow, many individuals and companies find that the use of a private aircraft provides a better, more efficient form of transportation for business travel.

However, whether owning your own private aircraft or traveling on an employer-provided aircraft, the tax rules relating to aircraft expenses are complex and must be considered before deciding on the approach to business travel.

There are many factors that determine the deductibility of an aircraft's expenses. The baseline factor is determining whether the expense is *ordinary* and *necessary*. Typically, an expense is ordinary if it involves a common and accepted business practice. The more difficult challenge is often proving whether an expense is necessary. To be considered necessary, an expense must be appropriate and helpful. That expense does not, however, have to be considered indispensable to be necessary, and need only help the business in some way. For example, if the aircraft

provides the traveler with direct access to destinations, flexible scheduling and fewer overnight stays, it could be considered as necessary. In addition to being ordinary and necessary, the expense must also be considered *reasonable* in nature. A reasonable expense is one that is not considered lavish or extravagant. To establish whether the expense of the aircraft is reasonable, it is typically helpful to show that the private aircraft saves significant time for the passengers, provides additional privacy and security and enables the passengers to attend more meetings and be more functional at such meetings.

One of the main considerations under the ordinary and necessary business expense test is whether the business conducted on the trip is the primary purpose of that trip. The primary purpose of a trip can be determined by factors such as:

- **Relative Time on Business and Personal Activities** - The amount of time spent on business vs. personal activities is an important consideration when determining the trip's primary purpose. For example, when someone travels to a destination and spends one week on business matters and five weeks on personal matters, the trip will most likely be treated as personal.
- **Existence of an Agenda** - IRS emphasizes the significance of having an agenda and other good documentation as evidence that the trip is related to business.
- **Location of the Conference/Meeting** - Where the conference or meeting is held is another important factor when determining whether the trip is for business. For instance, if the conference is held at a resort property, the primary purpose of the trip may be more difficult to justify as business. This is not to suggest that a business meeting must be held in a less desirable location, just that IRS may more closely scrutinize a business trip that happens to be at a resort.
- **The Presence of a Spouse or Guest** - If the taxpayer travels with his/her spouse or other guests, the related travel expenses are deductible only if the following requirements are met; 1) the spouse or guest is an employee of the taxpayer, 2) the spouse or guest is traveling for a genuine business purpose and 3) the travel expenses would be deductible by the spouse or guest individually. Common examples of genuine business purpose travel may include performing clerical functions, acting as a business manager or attending business seminars.

Once the above tests are met, the next step is the calculation of deductible expenses. Depending on whether the aircraft is used by a sole proprietor or disregarded entity, or whether the flights are employer-provided, there are different methods of allocating an aircraft's expenses.

Sole Proprietors/Disregarded Entities

A sole proprietor flight refers to a flight by which an individual is provided a flight for him or herself on an aircraft either wholly owned or leased from a third party rather than having it supplied by an employer. The sole proprietor rules also apply to flights provided by a disregarded single member entity to its sole owner. The business use of a sole proprietor's flight is determined based on the primary purpose of a flight rather than on a per-passenger basis. In those cases where an aircraft is used for business purposes, the expenses are allocated based on the proportion of the miles or hours of the flight related to business use.

One benefit of a sole proprietor's flight over an employer-provided flight is that the presence of a guest is disregarded when a flight is primarily for business use. A major distinction between a sole proprietor's flight and an employer-provided flight is that a sole proprietor cannot deduct expenses that relate to a personal use flight. In addition, the imputed income rules typically do not apply to a sole proprietor flight as there is no employer-employee relationship between the traveler and the aircraft provider.

Employer-Provided Flights

Typically, when an employer provides a personal flight to an employee, the value of the flight must be reported as a taxable fringe benefit to that employee. In order for an employer to then properly allocate deductible and nondeductible expenses, they must divide flights into the following three categories:

- **Business Flights** - If a flight is deemed ordinary and necessary to the company's normal operating activity, then the flight would be considered business travel. When a flight is considered business travel, all of the allocated costs are generally deductible.
- **Personal Non-Entertainment Flights** - Personal non-entertainment flights, such as commuting, traveling for a funeral, or traveling to see an advisor or physician, are not considered for entertainment purposes. However, personal non-entertainment flights are considered a taxable fringe benefit provided to the employee and therefore income must be imputed to the employee, or the employer must be reimbursed for the use of the aircraft. Most employers will use the Standard Industry Fare Level (SIFL) notes when imputing income to a key employee or company owner.
- **Personal and Entertainment Flights** - The allocated expenses of personal and entertainment flights provided by an employer are not deductible. If a key employee flies for personal and entertainment purposes, the expense of the flight is deductible only to the extent that compensation has been imputed to the employee for the cost of the flight, or the individual has reimbursed the employer for the fair value cost of the flight. The employer's calculation must include all costs and use either the occupied seat method or the flight by flight method. Both methods allocate costs based on each passenger's purpose for traveling and not the purpose of the flight. In addition, both methods can be calculated using either hours or miles. The employer is then able to run the calculations various ways (under both methods and both hours and miles) and use the result that produces the best outcome.

Although flying private may be more common and convenient for business travel, IRS will often scrutinize business aircraft deductions. Therefore, it is important to know the deductibility rules of private aircraft travel and maximize the tax deductibility of such aircraft usage. In addition, any reimbursement policy must also comply with the Federal Aviation Administration (FAA) rules.



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Founders and Exec's Beware Part 1: The Options for Options Costly Tax Trap



Young companies often offer stock options to a prospective executive team in order to attract and retain them, as well as motivate them to drive the business to success.

The Story

Unlike outside investors, whose role it is to provide cash capital to the business, the executive team provides their human capital. Unfortunately for many of these executive teams, the cash contributors are more often in a position to value their contribution to the company considerably higher than the team's contributions. Over time, this contribution disparity can result in dilution of equity granted to the executive team.

The Trap

Stock options are great tools in the finance world because an option owner can participate in the potential appreciation in a stock without having to outlay the cash for the investment. Unfortunately for executives, stock options granted to employees (other than Incentive Stock Options) also create ordinary income when they are exercised. Conversely, if the individual had owned the stock from the beginning, rather than an option, a sale of that stock would be taxed at the lower capital gains rate.

The Opportunity

In a young company, where the early stock price is relatively low, executives should consider negotiating for outright stock grants rather than options. With this model, the company grants restricted shares to the employee at the outset. The restrictions are often identical to the vesting schedule that would otherwise be customary for stock options. However, an important difference between restricted shares and stock options is that, if structured correctly, the executive is taxed at the more favorable capital gains rate when the shares are sold.

Some Details

Restricted stock grants can be tax-free on the date of the grant. However, in young companies where the value is very low, the recipient can elect to treat the grant as taxable as of the grant date. The election (a so-called *83-B election*) must be filed with IRS no later than 30 days after the grant and it must declare the value of the stock as of the grant date. Since the value of the stock is often low and this value is considered the taxable income, the corresponding tax is often nominal.

It should be noted however that in the current market environment, there are some new companies that begin with substantial initial valuations. This can result in a Restricted Stock grant that has substantial up front value and therefore greater tax cost. In, [*Views from the Inside: Equity is a wonderful incentive*](#), some solutions to this issue are examined.

Many founders and investors assume that stock options are the superior alternative when attempting to attract and retain an executive team. However, there are a variety of equity compensation plans, such as restricted stock, that may offer more efficient results for a particular company and its employees. A good plan can also allow companies to pick different alternatives for different employees or classes of employees to fit those individuals' tax and economic needs. Regardless of the type of compensation plan ultimately chosen, it is important to explore these options early.



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IRS Launches Initial Compliance Campaign Objectives: Part 2



In For the Record: IRS Launches Initial Compliance Campaign Objectives, the 13 initial income tax compliance campaigns announced by IRS are discussed.

These campaigns represent the current focus of the Large Business & International (LB&I) division's enforcement efforts:

- Related Party Transactions
- Tax-Free Repatriation of Property into the United States
- S Corporation Losses Claimed in Excess of Basis
- Land Developers Use of Completed Contract Method
- Deferred Variable Annuity Reserves & Life Insurance Reserves
- Energy Credit for Pre-Approved Projects
- Domestic Production Activities Deduction for the Film and Media Industries

- Offshore Voluntary Disclosure Program for Previously Declined or Withdrawn Taxpayers
- Form 1120-F Non-Filers
- Inbound Distributors and Transfer Pricing
- Micro-captive Insurance Contracts to Reduce Taxable Income
- TEFRA Linkage Plan Strategy
- *Basket Transactions* which Defer or Reclassify Income

The prior article focuses on the first three of these campaigns, each of which has specific importance to middle market companies. This article will focus on the next four. Although these four campaigns concern issues more common in specific industry sectors, the underlying laws and concepts are not limited to those sectors, and potentially impact taxpayers in other industries as well.

Land Developers Use of Completed Contract Method

For tax purposes, income from long-term construction contracts generally must be determined using the percentage of completion method. Under this method, taxpayers must recognize revenue as the taxpayer incurs allocable contract costs. As such, the taxpayer recognizes income in tax years leading up to the contract's completion.

However, in select instances, taxable income recognition can be deferred until the tax year in which the contract is completed through the use of the completed contract method. This method can be used to defer income recognition if either, (a) the taxpayer anticipates completing the contract within two years and has average annual gross receipts over the last three years of \$10 million or less, or (b) the contract is a home construction contract.

As part of the initiative's focus, IRS is concerned that taxpayers may be incorrectly classifying certain non-qualifying construction activities as home construction contracts and thus, improperly deferring taxable income. Examples of non-qualifying contracts include those that have total contract costs that are not 80% allocable to construction activities, and those that include costs that are not sufficiently attributable to buildings containing four or fewer dwelling units. As such, taxpayers using the completed contract method should confirm they meet the requirements (particularly if their income has increased in recent years). Taxpayers not currently using the completed contract method should likewise determine if they qualify for the deferral.

Deferred Variable Annuity Reserves & Life Insurance Reserves

In determining their taxable income, life insurance companies are permitted to deduct amounts they establish as a tax reserve for future claims. The *tax reserve* is measured as the greater of, (a) the net surrender value of the contract with regards to any penalty imposed on surrender but without regards to any market value adjustment or, (b) an amount determined by using an IRS prescribed method, which incorporates the applicable tax reserve method, the greater of either the applicable federal or State interest rate and IRS Commissioner's standard mortality tables. IRS is concerned that these tax reserves are being incorrectly determined and, as a result, companies may be under-reporting taxable income. IRS emphasis in this area reflects a more general focus on their attempts to increase compliance in areas subject to accounting estimates.

Energy Credit for Pre-Approved Projects

A substantial income tax credit is available to taxpayers who make investments in *energy property* and properly follow the requirements to obtain the credit. One such credit is the Qualifying Advance Energy Project tax credit

(Sec. 48C credit). This credit may only be claimed by an approved applicant who invested in a qualifying advanced energy project, received an acceptance letter related to the project in 2013 or earlier and completed the project within three years of the IRS certification letter date.

IRS has asserted that the Sec. 48C credit is sometimes being claimed by taxpayers who either were not pre-approved or have not completed the project within prescribed standards. Common violations of the standards have been noted to include unapproved alterations to the accepted project, the property not being placed in service on time, the property not being located in the United States and the basis of the property not being reduced to reflect the credit.

Domestic Production Activities Deduction for the Film and Media Industries

Broadly speaking, the Domestic Production Activities Deduction (DPAD) was introduced to incentivize domestic investment and production. The DPAD offers taxpayers a deduction equal to 9% times the lesser of, (a) taxable income before accounting for the deduction or, (b) Qualified Production Activity Income (QPAI). QPAI is calculated as Domestic Production Gross Receipts (DPGR) less the sum of costs of goods sold and other expenses, deductions and losses allocable to DPGR. This deduction applies to both traditional industrial companies as well as companies operating in industries such as retail, food and beverage, and film and media. IRS launched this campaign specifically to ensure that multichannel video programing distributors (MVPDs) do not include their distribution revenues as DPGR, thus leading to an overstated DPAD. IRS reasoned in a Chief Counsel Advice Memorandum that even if MVPD properly classify distributed subscription packages as qualified film, a class of qualified production property, the MVPD, are not the producers of such material and, therefore, these distributions are not DPAD-eligible activities. It remains unclear as to whether this campaign will be expanded to specifically identify other DPAD taxpayers.

Conclusion

Taxpayers should be aware that these 13 campaigns are the focal point of the LBI division's new compliance objectives. Although some of these campaigns appear to be specific to LBI taxpayers in certain industries, the implications from and responses to the campaigns can be much more far-reaching. The six remaining campaigns will be examined in subsequent issues of *For the Record*.



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First-Time Compliance with the R&D Payroll Credit



The Protecting Americans from Tax Hikes Act of 2015 (PATH Act) made permanent the federal Credit for Increasing Research Activities (Research Credit). It also expanded benefits to allow qualified small businesses to elect to designate up to \$250,000 of the Research Credit as an offset to the employer's contribution to social security tax (Payroll Credit)

This election can be made each year for up to five years. The statute instructs taxpayers to make the election for the Payroll Credit on an originally filed income tax return, and provides that the credit shall be applied against the social security component of FICA payroll tax beginning with the first full quarter after the income tax return is filed. The Payroll Credit is then claimed on Form 8974, *Qualified Small Business Payroll Tax Credit for Increasing Research Activities*, which must be filed quarterly with Form 941, *Employer's Quarterly Federal Tax Return*, for each quarter in which the Payroll Credit reduces the amount of payroll tax due.

What Were the Challenges of Claiming the Payroll Credit in the Second Quarter of 2017?

The 2016 calendar year was the first tax year for which the Payroll Credit election could be made. If a qualified small business filed its 2016 income tax return with the election in the first quarter of 2017, it was eligible for benefits in the second quarter. However, questions regarding the mechanics of the credit and a widespread inability of payroll tax service providers to process Form 8974 meant that many taxpayers eligible for benefits did not receive them. In this first year, as they had typically done in the past, claimants generally made full deposits towards the employer's contribution to social security. If a claimant's payroll tax provider was capable of filing Form 8974 for the second quarter, the initial form filed with Form 941 for the period ended June 30th functioned as a refund claim instead of a credit against a payment obligation, thereby creating a lag in the credit's timing.

Has IRS Issued Guidance to Address these Problems?

On March 30, 2017, IRS published Notice 2017-23 which announced limited relief from the original return requirement for the Payroll Credit election. The Notice allows taxpayers to make the Payroll Credit election on an amended income tax return, if the amended return is filed no later than December 31, 2017. The temporary extension to make the Payroll Credit election provided welcomed relief to taxpayers intent upon filing 2016 income tax returns by the original due dates in the second quarter, and to payroll tax providers that could not implement e-filing capabilities around Form 8974 in time to process second and third quarter claims.

Additionally, on July 31, 2017, IRS published Memorandum AM 2017-003 in which the mechanics of the Payroll Credit were finally confirmed to be a reduction to the deposits an employer would otherwise make towards its quarterly FICA payroll tax liability on a per pay period basis. The Memo also advised taxpayers that Payroll Credit elections made on amended income tax returns pursuant to Notice 2017-23 will be applied prospectively to future quarterly payroll tax liabilities, and not against payroll taxes paid in quarters that predate the Payroll Credit election.

What if my Payroll Tax Service Couldn't Process My Payroll Credit Claim in the Second Quarter?

Eligible taxpayers with payroll tax services that could not process second quarter claims should complete Form 941-X to show an overpayment of FICA payroll tax equal to the amount of the employer's contribution to social security that was allowed to be offset by the Payroll Credit in the second quarter. Taxpayers should then attach Form 8974 to Form 941-X and check box two on that form to have their claim processed as a refund. The standard three-year statute of limitations applies to these refund claims. Third quarter claimants who did not begin reducing payroll tax deposits with the first pay cycle of the third quarter should consult their payroll tax service provider to determine whether they can begin reducing deposits immediately, or if they should follow the above refund procedures for third quarter claims.

What Actions are Required to Claim Payroll Credit Benefits for the Remainder of 2017?

Procedures around the Payroll Credit remain challenging because the benefit can only be obtained through the coordinated efforts of multiple service providers. The income tax advisor is likely to prepare the Research Credit claim and make the Payroll Credit election on the income tax return. However, the payroll tax advisor has to file the claim and calculate the reduction that should be applied to the deposits remitted for each pay period in the subsequent quarter. Often, neither advisor can complete Form 8974 on its own because the form incorporates data from both the income tax return and the payroll tax return for the relevant quarter.

As a practical matter, payroll tax service providers have no way of knowing which of their clients conduct qualified research and development and may file a Payroll Credit claim. To solve this problem, payroll services are implementing their own procedures for clients to inform them of a pending Payroll Credit claim. This information has to be provided prior to the first pay period of the quarter in which deposits should be reduced, or the credit will not be applied to the earliest deposits due. As part of their processes, many payroll tax services are setting internal deadlines for clients to submit their Payroll Credit data, adding a second layer of administrative deadlines to the tax return due dates.

The following table describes the key dates and action items that must be completed to process Payroll Credit claims for the remainder of 2017.

Date	Action Item
September 15, 2017	Extended 2016 income tax return due date for partnership and S corporation returns.
September 30, 2017	Qualified small business 2016 income tax returns filed before the end of the third quarter are eligible for reduced payroll tax deposits in the fourth quarter of 2017.
October 15, 2017	Extended 2016 income tax return due date for C corporation and individual returns.
October 31, 2017	Form 941 due for the third quarter of 2017. Form 8974 should be filed with the quarterly return if the 2016 income tax return was filed in the second quarter of 2017.
December 31, 2017	Deadline to make the Payroll Credit election on an amended 2016 income tax return. Qualified small business 2016 income tax returns filed before the end of the fourth quarter are eligible for reduced payroll tax deposits in the first quarter of 2018.
January 31, 2018	Form 941 due for the fourth quarter of 2017. Form 8974 should be filed with the quarterly return if the 2016 income tax return was filed in the third quarter of 2017.

Despite IRS guidance, important questions about the Payroll Credit remain unanswered. It is therefore critical that taxpayers confirm specific procedures, deadlines and required documentation with their payroll services as soon as possible. That said, as taxpayers enter the second and third round of quarterly compliance with this important new tax incentive, the lessons learned from first-time compliance efforts will benefit taxpayers and tax providers alike.

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