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Client Alert

A report for clients and friends of the firm

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The Internal Revenue Service Provides Guidance on Golden Parachute Rules in the Context of Bankruptcy

In recently issued Revenue Ruling 2004-87, the Internal Revenue Service (the "IRS") provided guidance on the application of the golden parachute excise tax rules in bankruptcy settings.

The Internal Revenue Code (the "Code") imposes a dual penalty on excess parachute payments to discourage substantial payments to top executives and certain other individuals (statutorily referred to in the Code as "disqualified individuals") in connection with changes in corporate control to discourage substantial payments to such disqualified individuals. Section 280G of the Code denies the corporation a deduction for any excess parachute payments, and Section 4999 of the Code imposes on the disqualified individuals a nondeductible 20% excise tax on these payments. In general, "excess parachute payments" are the payments made to disqualified individuals that are contingent on a change in effective ownership or control of a corporation or in the ownership of a substantial portion of the assets of a corporation that exceed the disqualified individual's base amount (which is statutorily determined). The IRS issued final regulations on Section 280G in August 2003, but did not address issues involved in bankruptcy situations. This Revenue Ruling has closed that gap. The IRS addresses four specific situations in the Revenue Ruling.

Situation 1.

A public corporation files for Chapter 11 bankruptcy. Pursuant to the approved Chapter 11 plan, the corporation's common stock is cancelled and new shares are issued, with 75% of the shares distributed to unsecured creditors and 25% percent to certain shareholders in proportion to their pre-organization holdings. No single unsecured creditor will receive 20% or more of the company's common stock, and the new board of directors is established by the pre-organization board of directors.

The IRS determined that there is no change in ownership or control because (1) no person (or persons acting as a group) acquired more than 50% of the fair market value or voting power of the corporation; (2) no person (or persons acting as a group) acquired 20% or more of the outstanding stock within a 12-month period; (3) the new board of directors was approved by the pre-reorganization board; and (4) there was no acquisition of assets. The fact that the unsecured creditors were represented by a committee in creating the reorganization plan and that the reorganization plan provided for the creditors to receive stock instead of cash was not indicative of any intent by the unsecured creditors to act as a group to obtain control of the corporation.

Situation 2.

The facts of this situation are the same as in Situation 1, except that after the reorganization, the largest creditor will own 25% of the outstanding shares of the corporation.

The IRS determined that a change in control in the corporation is presumed to have occurred because one creditor acquired 20% or more of the corporation's stock within a 12-month period. However, this presumption may be rebutted by a showing that the largest creditor will not act to control the management and policies of the corporation.

Situation 3.

A public corporation files for bankruptcy under Chapter 11 and sells more than one-third of its assets to another corporation, which triggers certain payments to a disqualified individual. The shares of the corporation have been de-listed and are not traded on any other exchange or any other market, including any over-the-counter market (e.g., the pinksheets, the over-the-counter bulletin board, the automated confirmation transaction service, or any similar market). After notice and a hearing, the bankruptcy court approves the sale of assets and approves the payments to the disqualified individual as administrative expenses necessary to preserve the bankruptcy estate.

The IRS determined that there is a change in ownership of the corporation since another corporation acquired more than one-third of the total gross fair market value of all of the assets of the debtor corporation. However, the IRS held that the payments were exempt from the definition of a parachute payment because it had become a non-public corporation and satisfied the shareholder approval requirements. The corporation's stock was not readily tradable on an established securities market immediately before the change in ownership and the shareholders' approval and disclosure requirements have been met by the approval of the bankruptcy plan by the bankruptcy court. The bankruptcy court's approval served as a factual finding that the payments are actual, necessary costs and expenses of preserving the bankruptcy estate, thereby protecting the estate and the ultimate owners from unnecessary or excessive payments made to executives.

Situation 4.

The facts of this situation are the same as in Situation 3, except that the stock of the corporation is tradable on an over-the-counter market after being de-listed.

The IRS determined that the payments to the executive were exempt from the definition of a parachute payment despite the common stock being traded on an over-the-counter market. The IRS determined that the trading of stock while the corporation is a debtor in bankruptcy is impaired; thus, the stock is not considered "readily tradable" under Section 280G and can be treated as a non-public corporation.

Effective Date

Revenue Ruling 2004-87 applies to any payment that is contingent on a change of ownership or control if the change in ownership and control occurs on or after July 19, 2004. An exception to this effective date is provided for a bankruptcy debtor with securities traded on an over-the-counter market. Such a debtor's securities are not considered "readily tradable" for purposes of the shareholder approval non-public corporation exemption discussed above, even if the change in ownership or control occurred prior to July 19, 2004.

The IRS has requested comments as to what extent the definition of "readily tradable" under Section 280G should exclude stock that is tradable on an over-the-counter market. Comments to the IRS must be submitted by October 18, 2004.

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Client Alert

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