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Stranger in a Strange Land: Surprising Applications of U.S. Golden Parachute Rules in Cross-Border Transactions

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Background

The "golden parachute" excise tax regime under Internal Revenue Code Sections 280G and 4999 ("Section 280G" and "Section 4999", respectively) is at the core of both public and private U.S.-based transactions. While often overlooked, it is crucial to remember that the issues raised by Sections 280G and 4999 can – and do – apply to transactions that do not have a clear U.S. nexus. Careful attention should be paid to golden parachute considerations in any cross-border, non-U.S. transaction if a non-U.S. corporation at any level of the transaction structure (1) employs a U.S. taxpayer or (2) takes a U.S. compensation tax deduction.

Sections 280G and 4999 provide for a dual penalty on certain significant payments that are contingent on a change in control of a corporation to certain significant shareholders, officers, and other highly compensated individuals ("disqualified individuals"). The corporation may lose a compensation deduction, and/or (note, the two do not depend on each other) the individual may face a 20% excise tax, in addition to ordinary income tax, on such payments. Below is a brief summary of the golden parachute tax parachute provisions, and an example of how they may apply to a transaction involving two non-U.S. corporations.

When Do the Golden Parachute Tax Provisions Apply?

Sections 280G and 4999 may apply when a public or private corporation undergoes a change: (1) in the ownership (e.g., more than 50% of the corporation) or effective control (e.g., change in majority of the Board of Directors, or more than 20% of the voting power) of a corporation; or (2) in the ownership of a substantial portion of the assets of a corporation. Section 280G does not apply to S-corporations (whether or not they elect S-corporation tax status), to partnerships or to LLCs (other than those that elect to be taxed as a corporation). But if any corporations are involved in the overall transaction structure of the target entity, including subsidiaries, the golden parachute rules may apply.

Who is a Disqualified Individual?

A disqualified individual is any individual who, at any time during the 12-month period prior to the change of control is (1) an employee or an independent contractor of the corporation; and (2) an (a) officer, (b) 1% shareholder or (c) highly compensated individual, with respect to the corporation ("HCI"). The officer determination is based upon a variety of factors, including the individual's duties. An HCI is generally defined as the lesser of (1) highest paid 1% of the employee population or (2) 250 highest paid employees (compensation must be in excess of the IRS Highly Compensated Employee compensation limit, which is $135,000 for 2022).

When is a Payment Contingent on a Change in Control?

A payment that would not have been made but for the change in control is considered to be contingent on a change in control for purposes of the golden parachute tax provisions. Additionally, payments are generally presumed to be contingent on a change in control if the payment occurs within one year before and ending one year after the change in control. However, a payment is not contingent on a change in control if it is substantially certain that the payment would have been made whether or not a change in control occurs.

Golden Parachute Payment Thresholds

Payments contingent on a change in control constitute “parachute payments” if the aggregate present value of such payments equals or exceeds three times a disqualified individual’s “base amount.” “Base amount” is the average annual compensation includable in the disqualified individual’s gross income for the five completed calendar years preceding the change in control date (or if employed by the corporation for fewer than five full calendar years, the compensation averaged over the years during which the disqualified individual was employed), excluding one-time or other non-recurring payments (typically, signing bonuses). If payments contingent on a change in control exceed three times a disqualified individual’s base amount, then the corporation will lose the compensation deduction, and the disqualified individual will be subject to a 20% excise tax, in addition to ordinary income tax, on all payments contingent on the change in control that exceed one times the disqualified individual’s base amount.

Non-U.S. Corporation Example

An example will help illustrate how the golden parachute tax code provisions could apply where there is no U.S. corporation in the transaction or where this no U.S. taxpayer in the transaction.

Assume that a U.K. Corporation acquires 100% of a Canadian corporation and that the CEO of the Canadian corporation is a U.S. taxpayer (i.e., the CEO has the obligation to file taxes in the United States). If that individual receives payments contingent on a change in control that total $6 million and the individual’s base amount is $1 million, the payments would be parachute payments because the $6 million contingent payments exceed three times the individual’s base amount (i.e., 3 * $1 million). Therefore, $5 million (i.e., an amount equal to one times the individual’s base amount – the “excess parachute payment”) will be subject to the 20% excise tax (i.e., an aggregate of $1 million). This is so even where both payors are non-U.S. entities and even if the CEO is not physically present in the U.S., so long as the CEO is a U.S. taxpayer. It is worth noting that if the corporation undergoing the change in control and making the contingent payments in the above example were a U.S. corporation, but the CEO was not a U.S. taxpayer, the U.S. corporation’s compensation deduction would nevertheless be disallowed on the $5 million excess parachute payment, but the CEO would not generally be subject to the 20% excise tax.

Shareholder Approval Exception for Private Companies

For private companies, there is an exception that may apply so that the excise tax and the deduction disallowance provisions will not apply. To be eligible for this exception, the disqualified individuals need to waive their rights to the excess parachute payments and more than 75% of the shareholders of the corporation undergoing a change in control need to approve the payments. Once approved by shareholders, the payments may be made without having the excise tax or deduction disallowance provisions apply. This shareholder approval exception applies to non-U.S. private companies just as it does for U.S. private companies.

Conclusion

It is easy to see how the golden parachute tax code provisions could be overlooked in a transaction that has no clear nexus to the U.S. However, because of the significant tax consequences associated with these provisions, it is worth consulting with your U.S. counsel, so that the parties can be apprised of any potential issues and plan ahead if the target corporation can avail itself of the shareholder approval exception.

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