Pearl Meyer

TRENDS & ISSUES

Think the Tax Gross-Up is Obsolete? Not Necessarily

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We're on the record with others in thinking that excise tax gross-up provisions in new agreements are a pretty rare occurrence. In fact, for the most part, we have been under the distinct impression that these types of provisions have been on the road to extinction. Since the late 1990s and early 2000s, we've watched companies, under pressure from shareholders and their advisors, eliminate these provisions from legacy change-in-control ("CIC") and severance agreements and vow not to include the entitlements in any new agreements going forward. But in our work advising companies on pending transactions and reviewing public "say-on-golden parachute" disclosures, we stumbled upon a minority of companies adopting excise tax gross-up provisions shortly before a transaction's close. And while shareholders seem to have expressed opposition to the gross-up additions in the say-on-golden parachute vote, those same shareholders overwhelmingly supported the vote to approve the associated transactions.

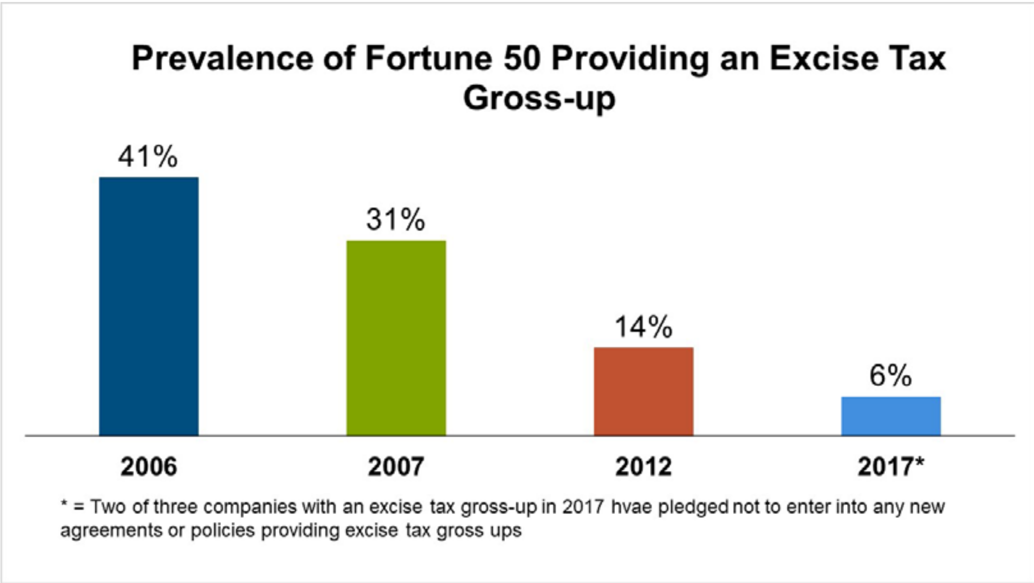
Background on tax gross-ups and their decline in recent years

Companies often provide protections to executives in connection with CICs and/or as a result of terminations following CICs. Proponents believe these go a long way in aligning executive and shareholder interests by allowing executives to maintain objectivity in the wake of an impending deal. The thought is, without these, management might be more likely to resist valid purchase offers out of real fears of losing their jobs. CIC benefits, also known as "golden parachutes," often take the form of enhanced severance payments, benefits, and acceleration of unvested equity.

In response to the increasing prevalence of CIC arrangements that resulted from a corporate hostile takeover wave in the early 1980s, Internal Revenue Code Section 280G ("280G") was adopted to Congress to discourage companies from paying golden parachute payments. Under the 280G rules, if the present value of the CIC payments to an executive exceeds his/her "safe harbor" (that is, three times an executive's average taxable compensation over the five most recent calendar years preceding the CIC or period of service less $1 (“base amount”)), a company loses tax deductions for the amounts considered “excess parachute payments.” Additionally, an executive is required to pay a 20 percent excise tax on any excess payments as a penalty for receiving them.

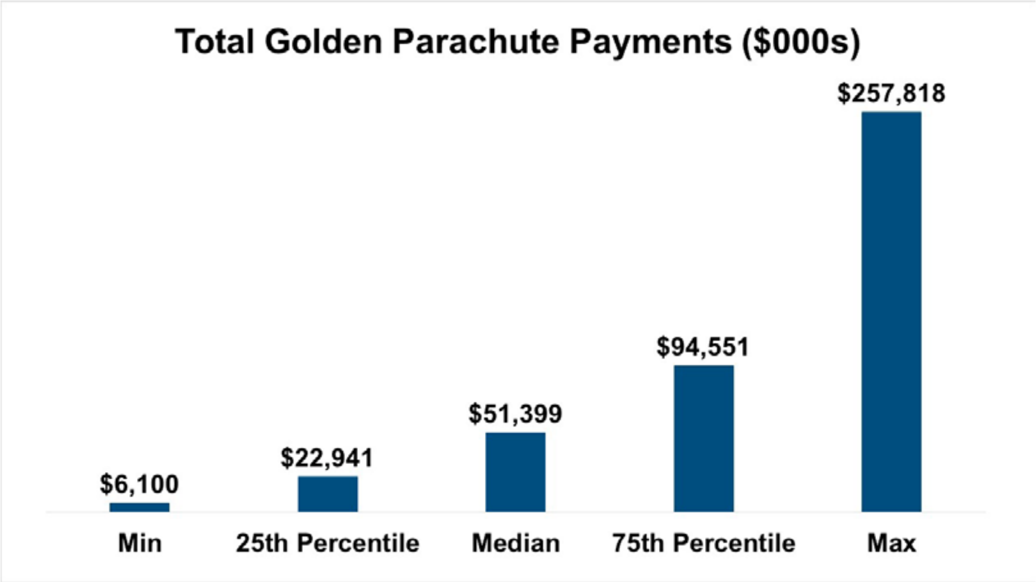
While 280G was meant to discourage the practice of golden parachute arrangements, it had the opposite effect. By the late 1990’s/early 2000’s, CIC arrangements, including the costly practice of grossing-up (i.e., tax protecting) executives on any associated excise taxes, was fairly standard.

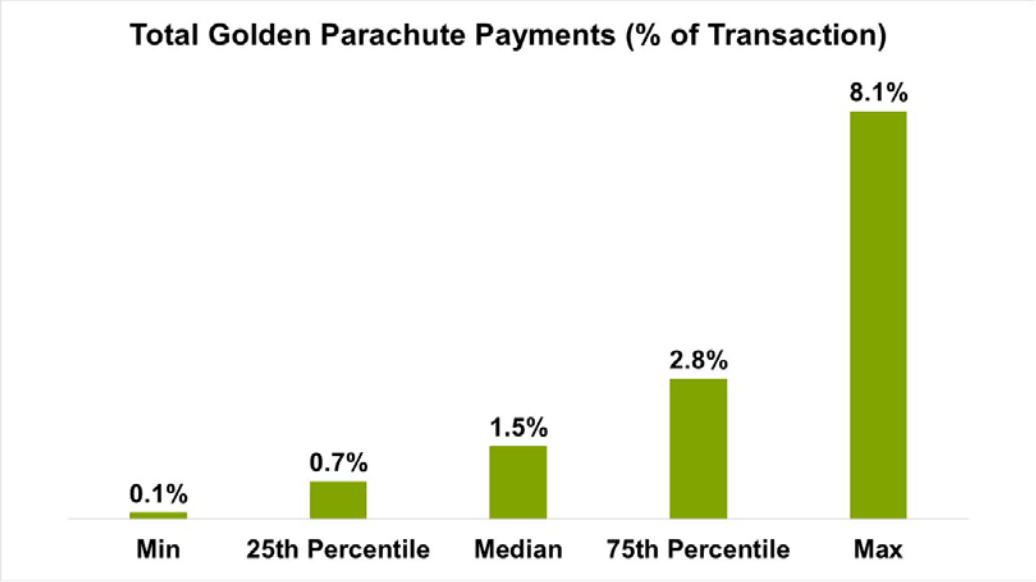
Institutional shareholders and their advisors have long held the view that providing excise tax gross ups is a very bad pay practice. And with the adoption of the say-on- pay rules in 2011, shareholders can now express their views on executive pay practices, both as part of the normal compensation program each year and as part of the transaction process (i.e., the say-on-golden parachute vote). As a result, since the early 2000’s, we have watched as companies have eliminated excise tax gross-up provisions from legacy agreements and vowed not to include them in any new agreements going forward.



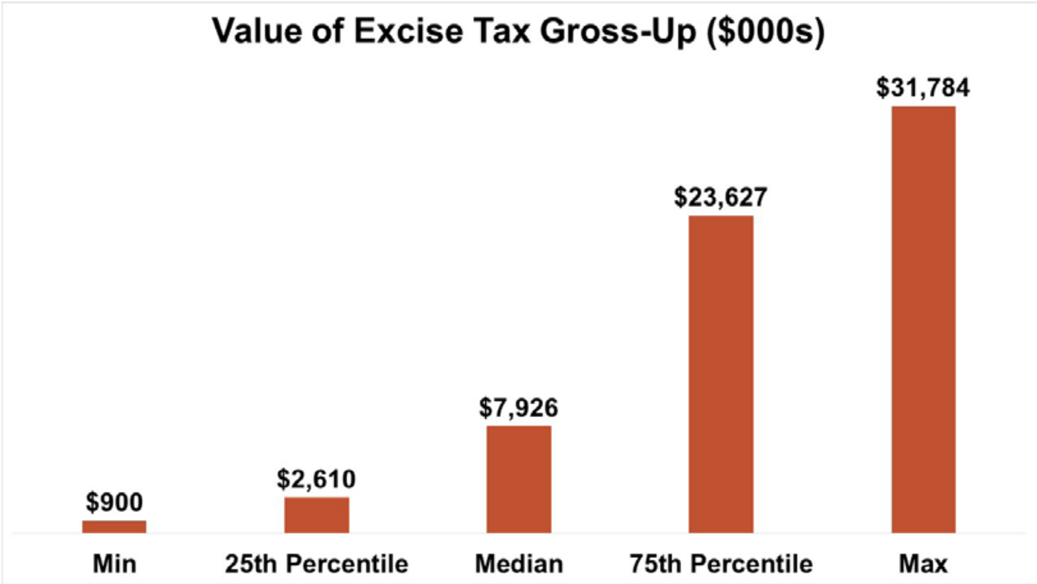
“Last Minute” Excise Tax Gross-Ups

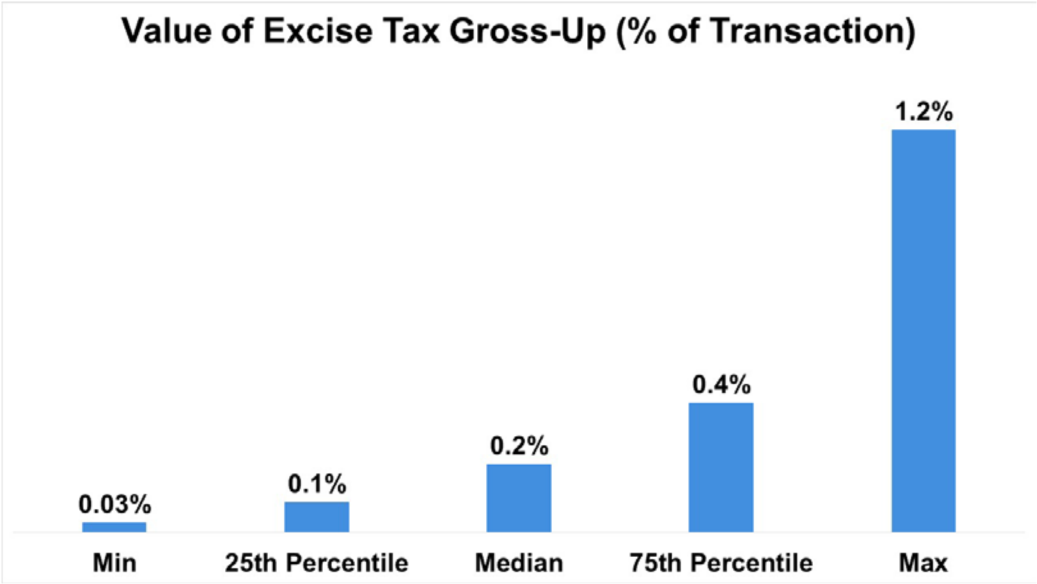
We identified 27 examples of companies that did not have excise tax gross-up provisions (before a CIC) but added one or more of these shortly before the closing of a transaction. The examples we found were found in disclosures relating to transactions occurring between 2012 and 2017. These examples spanned various industries and transaction sizes.



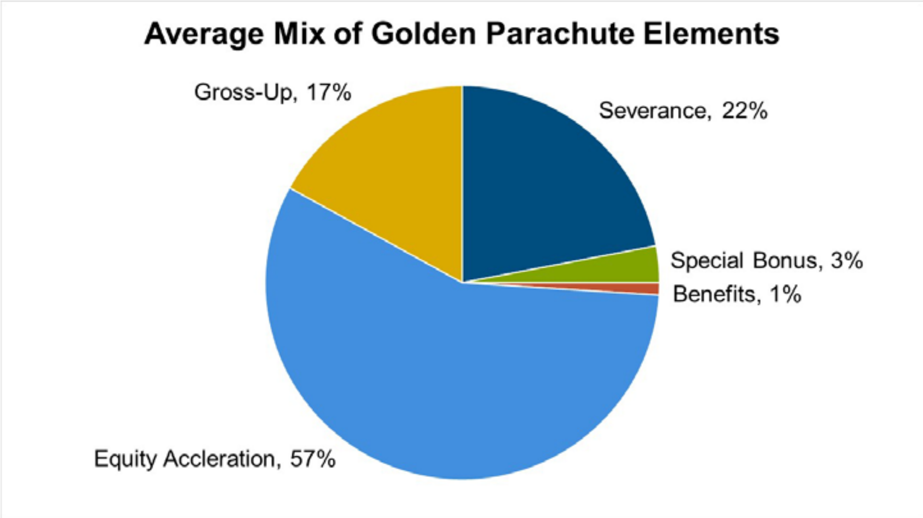


The value of the excise tax gross-ups provided in these cases was also substantial ranging from $900,000 to $32M. As a percentage of the transaction’s value, total golden parachute payments ranged from 0.03% to 1.2%.





While the “costs” of the excise tax gross-ups were very significant, the value of accelerated equity represented the most significant portion of the total golden parachute packages.



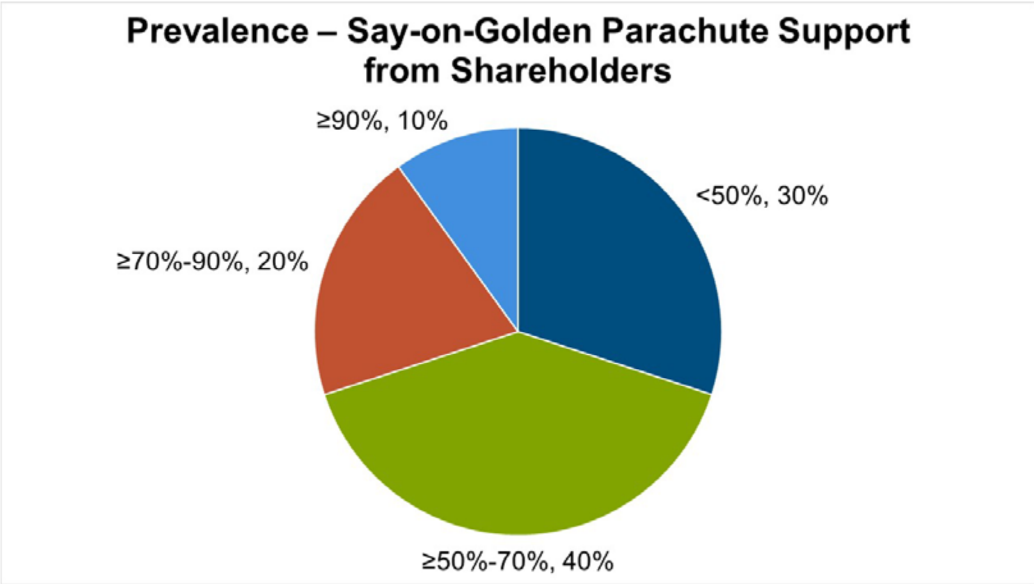
The vast majority of companies making last minute excise tax gross-ups (70%) did not provide a rationale for implementing them—we surmise, perhaps hoping to curb some of the negative attention that often results from shining a spotlight on these actions.

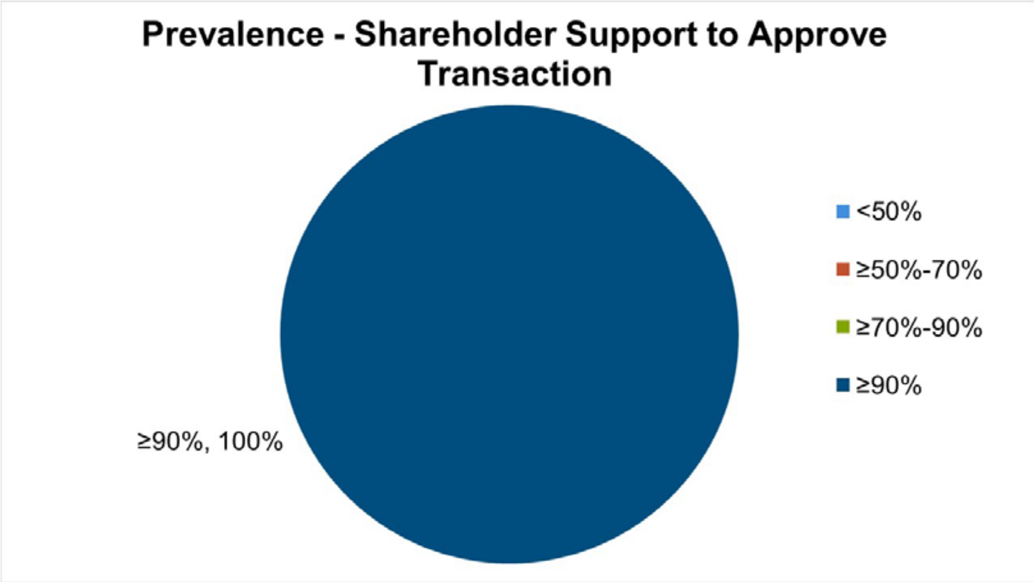
Among the minority of companies that offered some rationale for the taking these actions we found three common justifications:

- ***Alignment with Shareholders.*** The value of equity acceleration represented the majority of the golden parachute payments which was driven by the deal price negotiated by executives. Securing the best price was in the best interests of shareholders and the 280G excise tax imposed on executives was punitive compared to the value delivered to shareholders.
- ***Retention.*** Special arrangements were needed to retain key executives during the transition period following the CIC.
- ***Consideration for Restrictive Covenants.*** The excise tax gross-up was provided in consideration for entering into a restrictive covenant agreement where executives would be subject to non-competition and non-solicitation provisions for a period of time after the transaction and their termination.

In seven of the companies that had implemented 280G gross-ups, no advisory say-on-golden parachute vote was required in the transaction process.

However, in the remaining 20 companies, the transaction required a shareholder vote. In these transactions shareholders were much less supportive of the golden parachute payments than they were for the transactions themselves: 90% of these companies received less than 90% support in the say-on-golden parachute vote—in fact, 30% of the companies failed to receive 50% support. Conversely, shareholders provided overwhelming support for the overall transactions. The average vote to approve a transaction in this group was 99%.


Prevalence – Say-on-Golden Parachute Support from Shareholders
≥90%, 10%
<50%, 30%
≥70%-90%, 20%
≥50%-70%, 40%


Prevalence - Shareholder Support to Approve Transaction
<50%
≥50%-70%
≥70%-90%
≥90%
≥90%, 100%

Conclusions

To our surprise, excise tax gross-ups are not exactly "dead." We have found a minority of companies that have implemented these provisions shortly prior to impending transactions.

To be clear, most companies do not implement excise tax gross-ups in new agreements or shortly before a transaction. The decision as to whether to provide an excise tax gross-up is a difficult one. Boards must weigh whether the benefits to shareholders will ultimately outweigh their high costs as part of their fiduciary oversight. In addition, legal advisors may express concerns that implementing these types of provisions may further encourage shareholder lawsuits that so often accompany transactions these days.

About the Author

Margaret Black is a managing director in the Los Angeles office and a member of the firm's Technical Services team. She has consulted for over 25 years in the field of tax and over 20 years on all aspects of compensation and benefits matters. Margaret has extensive experience in issues related to corporate acquisitions, divestitures and restructurings, as well as with change-in-control provisions, IRC Sections 280G, 409A, and 162(m) compliance.

Jane Park, principal in the New York office, joined Pearl Meyer in 2005. With more than 10 years of experience, Jane advises public and privately-held clients on executive and non-employee director compensation issues. Her work is focused on pay governance, incentive plan design, pay-for-performance alignment, compensation benchmarking, proxy analysis, and special programs for IPO and M&A transactions.

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