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Gross-Ups: Down but Not Out

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With the U.S. national unemployment rate lingering above 9 percent, many are trying to identify the issues responsible for the current situation. Often, the blame is placed on excessive executive compensation.

In particular, tax gross-ups have become a major point of contention with shareholders, politicians and shareholder advisory services. Companies are torn between protecting their key executives and appeasing groups that have rallied against tax gross-ups. In general, tax gross-ups are payments provided by a company to cover an individual's tax liability related to some form of compensation. While some tax gross-ups are universally viewed as egregious (e.g., gross-ups covering perquisites such as personal travel or taxable life insurance, etc.), gross-ups on excise taxes in the context of a change in control transaction are inherently different because they may offer valuable relief to the executive, allowing him or her the opportunity to focus on the most advantageous outcome for shareholders without worrying about facing a substantial tax burden arising because significant shareholder value has been created.

To fully understand the excise tax gross-up, an understanding of Internal Revenue Code Section 280G is required. When a corporation is acquired by another company, both the corporation and its key executives can become subject to significant adverse tax consequences under the golden parachute provisions of Section 280G. Under these provisions, "parachute payments" to an executive exceeding the "safe harbor" limit create large penalties to both the corporation and the executive. Depending on the circumstances and the number of executives affected, the cost to the company and the executives can be significant.

Generally speaking, parachute payments are any payments made to or for the benefit of an executive that are contingent on a change in control of a corporation and that exceed the safe harbor limit. Generally, these payments include accelerated vesting of equity awards, severance payments and other change in control benefits. The safe harbor limit is equal to three times less one dollar (2.99x) the base amount, which is defined as the executive's average gross compensation over the five most recent taxable years ending before the date of the change in control. If an executive receives parachute payments exceeding this safe harbor limit, a 20 percent excise tax is imposed on all parachute payments in excess of the base amount. Section 280G also disallows the corporation a deduction for all parachute payments in excess of the base amount, called "excess parachute payments."

Historically, Alvarez & Marsal Taxand has completed a bi-annual survey identifying and quantifying the payments executives would receive upon a change in control, with based on information as disclosed in companies' 2009 proxy statements. This week's edition of *Tax Advisor Weekly* discusses trends in Section 280G excise tax protection and explores changes that occurred between the 2009 and 2010 proxy seasons.

Methodology
To evaluate the effect of changing tides in the marketplace, Alvarez & Marsal Taxand analyzed data concerning excise tax provisions for the CEO and the next four highest paid executives — other named executive officers (NEOs) — from 200 companies.

The companies chosen were those with the highest market capitalization based on 10 industry categories: consumer discretionary, consumer staples, energy, financial services, healthcare, industrials, information technology, materials, telecommunications and utilities. Information on excise tax protection related to changes in control was gathered from the companies' 2010 proxy season filings and other publicly available company documents. The data was then compared with prior-year data for the same companies, which is largely documented in the .

Generally, excise tax provisions fell into one of the following categories:

- Gross-up: The company pays the executive the full amount of any excise tax imposed. The gross-up payment thereby makes the executive "whole" on an after-tax basis. The gross-up includes applicable federal, state and local taxes resulting from the payment of the excise tax.
- Modified gross-up: The company will gross-up the executive if the payments exceed the safe harbor limit by a certain amount (e.g., $50,000) or percentage (e.g., 10 percent). Otherwise, payments are cut back to the safe harbor limit to avoid any excise tax.
- Cut back: The company cuts back parachute payments to the safe harbor limit to avoid any excise tax.
- Valley provision: The company cuts back parachute payments to the safe harbor limit if it is more financially advantageous to the executive. Otherwise, the company does not adjust the payments, and the executive is responsible for paying the excise tax.
- None: Some companies do not address the excise tax; therefore, executives are solely responsible for the excise tax.

Key Findings

- As shown in the tables below, about 5 percent of CEOs and other NEOs lost their gross-up protection between 2009 and 2010 (includes gross-up and modified gross-up).
- For CEOs, the use of valley provisions increased by about 2 percentage points and instances of no protection increased by about 3 percentage points. For other NEOs, valley provisions and no protection increased by about 2.5 percentage points.
- For both CEOs and other NEOs, the use of the cutback provision remained flat.

These tables show the percentage of CEOs and other NEOs with each type of excise tax protection in 2010, broken out by industry.

The graph below shows the percentage of CEOs and other NEOs whose excise tax protection changed from a gross-up to one of the other methods shown on the graph.

As shown in the graph above, nearly half of the companies that changed their gross-up provisions simply eliminated the gross-up without establishing another type of excise tax protection. Not only does this approach provide no protection to the executive, but it also may not be the most fiscally sound option for the company. Removing the excise tax gross-up provision may reduce the cash out-of-pocket cost to the company. But, as noted previously, Section 280G also disallows a deduction for excess parachute payments. Rather than remove the excise tax protection altogether, a company may wish to explore implementing a valley provision that would put the executive in the best after-tax position (other than using a gross-up) and could potentially preserve the company's deduction. Perhaps these companies have eliminated excise tax gross-ups in a rash decision to reduce the appearance of excessive executive pay, or to appease shareholders or shareholder advisory groups. Or perhaps they are simply unaware of other ways to approach gross-ups that leave the executive and the company in a better financial position.

Gross-Ups Going Forward

Of companies that currently provide gross-ups or modified gross-ups, nearly one-third have stated that they will approach excise tax gross-ups differently in the future. Generally, these companies have grandfathered current participants, but gross-ups will not be offered on a prospective basis. Certain industries show a greater tendency to modify future practices regarding excise tax gross-ups. For example, more than 30 percent of the companies that provide gross-ups or modified gross-ups in the healthcare, materials, telecommunications and utilities industries have stated they will eliminate or discontinue implementing gross-ups in the future. For the industrials sector, this figure is even higher (70 percent). However, no companies in the consumer discretionary or energy sectors made such a statement. While most companies do not provide a reason for removing or discontinuing excise gross-ups, we believe that much of this movement is a reaction to external pressures, primarily the influence of shareholder advisory services, including the organization Institutional Shareholder Services, which has deemed new or materially modified arrangements that provide for excise tax gross-ups as a "poor pay practice."

Other Findings

- By and large, companies do not clearly identify in arrangements or plan documents whether excise tax gross-ups are single trigger or double trigger benefits. A single trigger indicates that a change in control alone will entitle the executive to a gross-up payment, if needed (termination of employment is not required). A double trigger requires both a change in control and termination in order for gross-up protection to be provided. Companies should consider that not only could the uncertainty of the triggers spark a legal debate should a change in control occur, but it could also create problems for companies from a Section 409A prospective.
- It is important for companies to specify the order in which payments made upon a change in control (e.g., severance, bonus, long-term incentives, etc.) would be cut back in the event payments were required to be reduced under a cut back provision, valley provision or a modified gross-up. Many companies do not specify the cut back order in their agreements, but for those that do, lump-sum severance payments are most often the first to be reduced. As a practical matter (including running afoul of Section 409A), companies should specify the order in which payments will be reduced to ensure that the executive and the company are prepared if an actual change in control occurs.

Most companies presented relatively standard excise tax protections for their executives that can be classified into one of the five different categories noted previously; however, we observed some unique arrangements in our analysis:

- Two companies in our analysis have set time limits, or sunset provisions, for their excise tax gross-ups. For one company, the gross-up only applies if a change in control occurs in the first two years of employment. After the two-year period ends, the gross-up changes to a valley provision. The other company has stated that it will not include gross-ups in future agreements. However, its compensation committee has the discretion to use excise tax gross-up provisions if necessary to help recruit new executives. If a new agreement provides an excise tax gross-up, this protection will be subject to a two-year sunset provision.
- The most interesting treatment comes from two companies that provide modified gross-ups through change in control plans. However, these modified gross-ups are only available to the extent an individual is not an “executive officer” or one whose compensation is disclosed in the proxy. This may be an attempt to avoid scrutiny from shareholder advisory services, and it raises additional questions. Does an executive whose compensation is disclosed in the proxy one year but not the next become re-entitled to a gross-up?

Alvarez & Marsal Taxand Says:
Pressure from shareholders, politicians, shareholder advisory services and others has prompted many companies to reconsider their approach to excise tax gross-ups. While removing gross-ups or modified gross-ups may initially appease shareholders, it could have negative long-term ramifications. Firms need to explore all of their options to find the solution that best benefits the executive and shareholders. Companies wanting to remove gross-ups should consider implementing a valley provision that provides a benefit to the executive at no additional cost to the company. Not all policies fit a standard mold, and some firms use unique excise tax provisions to retain top talent. Lastly, to avoid Section 409A complications, companies should specify the order in which parachute payments are cut back and re-examine the exact events (single trigger vs. double trigger) that entitle the executives to the gross-up payment.

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