VENABLE LLP
Employee Benefits Alert
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Tidbits from the Trenches: Indemnifications, Gross-Ups and Code Section 409A

While much remains to be worked out about Section 409A of the Internal Revenue Code, one thing we know for sure: its ripple effects are far reaching and will change many previously common practices. Nowhere have we seen this more clearly than in corporate transactions. Since its enactment, Section 409A has been a drag on deal-making because its rules clearly compromise much of the flexibility that is crucial to productive negotiation and might well diminish the traditional safeguards that can smooth the road to closing. This alert focuses on one such safeguard – the indemnification of corporate executives against the financial consequences of events that might occur after closing, such as lawsuits or tax penalties.

SECTION 409A

For those of you who have not yet had to become familiar with Section 409A, it is important to know that this new section of the Internal Revenue Code applies not only to traditional deferred compensation arrangements, but also to severance arrangements, employment contracts, certain stock option plans, and virtually any other agreement between parties that promises compensation in one year that will be paid in a later year. Further, if Section 409A is violated by defective plan language, a questionable stock valuation, or even a settlement payout of a nonqualified pension claim, the burden of the violation falls on the employee. Specifically, the employee owes not only income tax on his or her deferred compensation (as determined under Section 409A), but also interest at a specified rate and a penalty of 20% of the included amount. This is an extreme consequence for an employee who may have had no control over the circumstances leading to the violation.

Indemnifications for Section 409A Violations

Because of the severity of the consequence, we have started to see some executives negotiating for Section 409A violation indemnifications in employment agreements as well as in transaction documents. These indemnifications generally include a partial "gross-up" payment limited to the amount of the penalty and interest. Some also require a full gross-up payment, intended to put the executive in the same after-tax position he or she would have been in prior to payment of the penalty and interest. These provisions are much like the Section 280G gross-ups for golden parachute payments, which themselves are fairly standard provisions in company plans and employment contracts.

The issue with these indemnifications and gross-ups under Section 409A is that any such promise of a future payment, whether for Section 409A or Section 280G purposes, may be a defective deferred compensation arrangement under Section 409A that creates the very consequence it was intended to correct.

What are the work-arounds? At this time, we are seeing a variety of approaches, including the following:

- Providing an executive with the indemnification provisions that he or she requests with a caveat that the provisions will be effective only to the extent permitted by Section 409A.
- Requiring reformation of an agreement to ensure the same economic benefit to the executive in another form.
- Doing nothing to change the language of indemnifications at this time and waiting for the final Section 409A regulations to be issued with hoped-for clarifications.

Each approach has its own risks and rewards, and until final guidance on Section 409A is issued (which we understand is expected to be any day now), there are no clear answers.

However, because gross-ups are in the air,[1] we thought that a review of how gross-ups work would be helpful at this time. What follows is a description of the mechanics of calculating the Section 280G "golden parachute" excise tax and related full gross-up.[2] A Section 409A full gross-up would be calculated in a similar fashion, except that, under Section 409A, the company's cost with respect to the gross-up payment generally would not be increased by the loss of the deductions related to the payment, as is the case with Section 280G.[3]

SECTION 280G GOLDEN PARACHUTE GROSS-UPS

If an executive becomes entitled to a golden parachute payment that exceeds a certain amount determined under Section 280G, the executive is personally liable for a nondeductible 20% excise tax on the amount of the excess, also as determined under Code Sections 280G and 4999. As a result, some executive compensation agreements include provisions promising an additional payment on top of the actual parachute payment to put the executive in the same economic position the executive would have been in had there been no excise tax ("gross-up provisions").

Gross-up provisions can be attractive to executives for obvious reasons. However, these provisions are very expensive for companies and their shareholders because of the often surprising magnitude of the gross-up payment. And the true cost of the payment is even more after taking into account any additional FICA contributions that the company must pay on the gross-up payment and the loss of any deductions related to the payment.

How is an Executive's Golden Parachute Excise Tax Liability Determined?

The key to understanding how golden parachute gross-up liabilities can become so large is to understand how the amount of an executive's "excess parachute payment" is determined. The steps in determining that amount are described below.

1. Determine the executive's "base amount."

   The base amount is calculated by averaging an executive's gross income (Box 1 on the executive's Form W-2 or an outside director's Form 1099-MISC) for the five calendar years ending before the year of the change in control.

2. Determine the executive's "safe harbor amount."

   The safe harbor amount is the amount of "contingent payments" an executive may receive without triggering an excess parachute payment subject to the 20% excise tax. The safe harbor amount is the amount that is $0.01 less than three times the base amount for the executive.

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[1] For example, additional interest in gross-ups has been generated by the new SEC executive compensation disclosure rules. Under those rules, gross-up payments made to certain executives of publicly traded companies are now subject to disclosure requirements. Specifically with regard to "potential post-employment payments," such as payments triggered by a change in control, a company is required to disclose a reasonable estimate of any such payment, including the estimated amount of the gross-up, plus a description of how the estimate was calculated.

[2] This discussion is meant to be a general review of the issues related to "grossing-up" an executive who becomes subject to an excise tax under the golden parachute rules of Internal Revenue Code Sections 280G and 4999. It does not, therefore, describe or discuss the many issues related to the application of Section 280G generally, including, *e.g.*, whether there has been a change in control for purposes of Section 280G, whether a particular executive is covered by Section 280G, or what payments are contingent payments and how those payments are valued. In addition, this discussion describes the calculation of the excise tax and the gross-up in general terms. The actual calculations can be quite complicated and generally require accounting expertise.

[3] At this time, a gross-up for Section 409A penalties is deductible except when the gross-up relates to an impermissible set-aside of deferred compensation under Section 409A(b)(3) as added by the Pension Protection Act of 2006. However, the inclusion of this approach in the PPA provision suggests the possibility that future legislation could expand the denial of gross-up deductions in other Section 409A situations.

3. Determine the total present value of all of the "contingent payments."

   A contingent payment is a payment in the nature of compensation that is contingent upon there having been a change in control with respect to the company. Note that any gross-up payment, as described below, is itself a contingent payment (subject to income, employment and excise taxes), and has to be included in this determination.

   Total present value is determined as of the date of the change in control that triggered the payment and is based on interest rates published monthly.[4]

4. Determine whether the contingent payments are a "parachute payment."

   The contingent payments are a parachute payment if the total present value of the contingent payments is greater than the safe harbor amount.

5. Determine the amount of the "excess parachute payment."

   If the value of the contingent payments is greater than the safe harbor amount, all parachute payments in excess of one times base are the excess parachute payment.

The excess parachute payment (i) is not deductible to the company, and (ii) is subject to the 20% excise tax because the executive is entitled to it only as a result of the change in control with respect to the company.

Example

Executive A is the President of a company that undergoes a change in control in 2007. The relevant facts are as follows:

Base Amount	$200,000	[5 year average compensation]
Safe Harbor Amount	$599,999.99	[3 x $200,000 - $0.01]

The safe harbor amount is the maximum present value of all contingent payments that Executive A can receive without triggering the 20% golden parachute excise tax.

- What are the excise tax consequences if the present value of the Executive A's contingent payments is $650,000?

Parachute Payment?	Yes	[$650,000 > $599,999.99]
Excess Parachute Payment	$450,000	[$650,000 - $200,000]
Excise Tax	$90,000	[$450,000 x 20%]

- What are the excise tax consequences if the present value of the Executive A's contingent payments is $600,000?

Parachute Payment?	Yes	[$600,000 > $599,999.99]
Excess Parachute Payment	$400,000	[$600,000 - $200,000]
Excise Tax	$80,000	[$40,000 x 20%]

[4] Code Section 280G requires present value to be determined by using a discount rate equal to 120% of the applicable federal rate ("AFR") as determined under the Code, compounded semiannually. The AFR changes monthly, making the exact calculation of the contingent payments at any time prior to a change in control difficult, if not impossible.

There are two things in particular to note about these rules, as demonstrated in the above example:

- The amount subject to the excise tax is not the amount by which the contingent payments exceed the safe harbor amount. The amount subject to the excise tax is much larger: it is the sum of the contingent payments less the base amount. So, where, as in the example above, an executive's base amount is $200,000, his or her safe harbor amount is $599,999.99 If the sum of the contingent payments made to the executive is $600,000, the amount subject to the excise tax is not $0.01 (the amount by which the contingent payments exceed the safe harbor); rather, it is $400,000 (the amount remaining after the base amount is subtracted from the contingent payments).

- These rules create an absolute bright line and there is no "de minimis" exception. As noted in the example above, if the contingent payments are only one penny too much, both the company and the executive are penalized with respect to an amount that is equal to two times the executive's base amount.

How is an Executive's Gross-Up Payment Determined?

As noted above, a gross-up provision is intended to put an executive in the same economic position the executive would have been in had there been no golden parachute excise tax. However, the direct and indirect costs of such a provision can be quite high. The price tag is driven by the fact that the company's payment of the excise tax is itself income subject to Federal, State and local income, employment and excise taxes. As a result, the gross-up amount includes not only the excise tax, but all the other tax payments that are generated by the initial payment.

There are various methods for calculating the amount of a gross-up payment. One method of calculating a gross-up is based on the following formula:

$$\frac{\textit{Total Excise Tax}}{\textit{(1 minus the Total Marginal Rate)}} = \textit{Total Gross-Up Payment}$$

The Total Marginal Rate consists of:

Excise Tax Rate	20.00%
Federal Tax Rate	35.00%
State Tax Rate	5.75%
FICA Tax Rate (Employee's Share) (1.45% Medicare Tax)	1.45%
Total Marginal Rate	**62.20%**

Using the $650,000 contingent payment in the example above, Executive A's excise tax payment of $90,000 triggers a total gross-up payment of $238,095.

$$\frac{\$90{,}000}{(1\text{-}62.20\%)} = \$238{,}095$$

Therefore, in order for Executive A to receive an additional $90,000 to pay his or her golden parachute excise tax liability, the company would have to pay the executive a total of $238,095. Out of this payment, the executive would pay:

Excise Tax	20.00% of $238,095	$47,619
Federal Tax	35.00% of $238,095	$83,333
State Tax	5.75% of $238,095	$13,691
FICA Tax (1.45% Medicare Tax)	1.45% of $238,095	$ 3,452
Total Taxes	**62.20%**	**$148,095**
Remainder of Gross-Up Payment		**$90,000**

Additional Costs: Employer's Share of FICA and Lost Deductions

In addition, to assess the true cost of the excess parachute payment and gross-up to the company, the company also must consider the additional FICA tax it owes on the gross-up payment and, more significantly, its lost deductions on the combined amount of the excess parachute payment and the gross-up payment.

The company will owe the employer's share of FICA on the excess parachute payment. In this example, that amount is $3,452 (1.45% of $238,095).

The company also will not be able to deduct either the excess parachute payment ($450,000 in the example above) or the total gross-up payment ($238,095 in the example above), for a total of $688,095 in non-deductible payments. Assuming a marginal corporate tax rate of 40% (combined Federal and State), the value of the company's lost deduction equals $275,238.

Therefore, in addition to the excess parachute payment itself, the total cost to the company of Executive A's excess parachute payment and gross-up is:

Gross Up Payment	$238,095
Lost Deductions	$275,238
FICA (Employer's Share) (1.45% Medicare Tax)	$ 3,452
Total Costs	**$516,785** **or** **$5.74 of cost to the company for every $1.00 of excise tax imposed on Executive A**

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As this alert describes, gross-up payments to make executives whole for any penalty or excise taxes that they may owe for excess parachute payments or Section 409A violations can be complex and costly. Venable is here to assist you in answering any questions that you have regarding the matters addressed in this alert. Please contact any of the attorneys listed below if you have any questions or require assistance.

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