

Understanding Section 280G in Change-in-Control Transactions

A Practical Guide to Golden Parachute Rules and Transaction Considerations

Introduction

Change-in-control (CIC) transactions frequently trigger complex executive compensation and tax considerations. Among the most consequential are the “golden parachute” provisions under Sections 280G and 4999 of the Internal Revenue Code (IRC).

When applicable, these rules may result in:

- A 20% excise tax imposed on impacted individuals
- Loss of the corporate tax deduction for excess parachute payments
- Increased transaction costs and administrative complexity
- Potential negotiation challenges among stakeholders

WHY IT MATTERS

Because Section 280G can materially affect transaction economics and executive outcomes, companies and advisors often evaluate potential exposure during mergers, acquisitions, private equity transactions, recapitalizations, and other liquidity events.

Authorities: IRC §§ 280G, 4999; Treas. Reg. § 1.280G-1.

What Is Section 280G?

Section 280G governs certain compensation payments that are contingent upon a CIC of a corporation. These payments, commonly referred to as “parachute payments”, may become subject to adverse tax consequences if they exceed specified statutory thresholds.

Generally, if parachute payments equal or exceed three times an individual’s “base amount,” the excess over one times the base amount may constitute an “excess parachute payment” subject to excise tax treatment under IRC § 4999 and loss of deduction under IRC § 280G.

The rules are highly technical and require careful analysis of compensation arrangements, transaction structure, historical compensation data, and timing considerations.

Authorities: IRC §§ 280G(b)(1), 280G(b)(2), 4999; Treas. Reg. § 1.280G-1, Q/A-1 through Q/A-6.

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When Does Section 280G Apply?

Section 280G generally applies when a qualifying CIC occurs. This may include:

Change in Ownership

A change in ownership generally occurs when a person or group acquires ownership of stock possessing more than 50% of the total fair market value or total voting power of the corporation.

Authority: Treas. Reg. § 1.280G-1, Q/A-27.

Change in Effective Control

A change in effective control may occur upon the earlier of either of the following:

- person or group acquires stock possessing 20% or more of the corporation's total voting power within a 12-month period; or
- A majority of the board of directors is replaced within a 12-month period by directors whose appointment or election is not endorsed by a majority of the incumbent board.

Special rules and exceptions may apply depending on transaction structure and ownership changes.

Authority: Treas. Reg. § 1.280G-1, Q/A-28.

Acquisition of a Substantial Portion of Assets

A change may also occur if a person or group acquires assets from the corporation having a gross fair market value equal to or exceeding one-third of the total gross fair market value of all corporate assets within a 12-month period.

Authority: Treas. Reg. § 1.280G-1, Q/A-29.

Whether a transaction constitutes a CIC depends heavily on the specific facts, ownership structure, and transaction mechanics involved.

Note: Private corporations that do not have stock readily tradable on an established securities market may qualify for the shareholder approval exception under IRC § 280G(b)(5), commonly referred to as the "280G cleanse." Strict procedural and disclosure requirements apply.

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Who Is Subject to Section 280G?

Section 280G applies to certain “disqualified individuals” (DQIs). A DQI generally includes any employee, independent contractor, or other person performing services for the corporation who falls into one of the categories below.

Officers

Any individual who is an officer of the corporation, or performs officer duties regardless of title, limited to a maximum of 50 employees (or, if fewer, the greater of 3 employees or 10% of all employees).

Authorities: Treas. Reg. § 1.280G-1, Q/A-15 through Q/A-18.

Highly Compensated Individuals (HCIs)

Any individual earning more than \$130,000 annually (indexed for inflation) who ranks in the top 1% of employees by gross compensation, limited to a maximum of 250 employees.

Authorities: IRC §§ 280G(c), 414(q); Treas. Reg. § 1.280G-1, Q/A-15 through Q/A-21.

1% Shareholders

Any individual who owns at least 1% (by value) of the corporation’s stock (including stock subject to options held by the individual and stock owned by related persons), note that IRC § 318 constructive ownership rules apply (i.e., trust beneficiaries, children, etc.).

Authorities: IRC §§ 280G(c), 318; Treas. Reg. § 1.280G-1, Q/A-15 through Q/A-18.

What Constitutes a Parachute Payment?

Parachute payments generally include compensation or benefits that are contingent upon a CIC transaction.

A payment is considered contingent on a CIC if it would not have been payable absent the transaction or if the transaction accelerates or increases the payment.

Common examples include:

- Cash severance payments
- Transaction bonuses
- Accelerated vesting of equity awards
- Retention or stay bonuses
- Deferred compensation arrangements
- Continued employee benefits
- Perquisites and other compensation-related items

In many cases, multiple compensation arrangements must be aggregated to determine total parachute payment exposure.

Authorities: IRC § 280G(b)(2); Treas. Reg. § 1.280G-1, Q/A-22 through Q/A-24.

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Automatic Presumption Rule

Compensation agreements entered into or modified within one year before the transaction closing date are generally presumed to be contingent on the transaction unless the facts and circumstances clearly establish otherwise.

This rule can significantly expand the scope of payments analyzed during a 280G review.

Authority: Treas. Reg. § 1.280G-1, Q/A-26.

When Do Excise Taxes Apply?

Not all parachute payments trigger excise tax consequences.

Generally:

- An individual's "base amount" is calculated using the individual's average annual taxable compensation from the five taxable years preceding the year in which the change in control occurs.
- If total parachute payments equal or exceed three times the base amount, excess parachute payment rules may apply.
- Once the threshold is exceeded, the amount exceeding one times the base amount generally constitutes an "excess parachute payment."

Excess parachute payments may trigger:

- A 20% excise tax imposed on the individual under IRC § 4999, and
- Disallowance of the corporate tax deduction under IRC § 280G.

Because these calculations are highly fact-specific, companies frequently perform modeling and exposure analyses well before transaction closing.

Authorities: IRC §§ 280G(b)(1), 280G(b)(3), 4999(a); Treas. Reg. § 1.280G-1, Q/A-34 through Q/A-39.

Why Timing Matters

The timing of a Section 280G analysis can materially affect the range of available mitigation strategies.

Early-stage analysis may provide additional flexibility to:

- Evaluate potential mitigation opportunities
- Structure compensation arrangements more efficiently
- Coordinate shareholder approval processes
- Assess transaction economics and executive outcomes
- Align legal, tax, HR, payroll, finance, and deal teams
- Address documentation and valuation support requirements

When analysis occurs late in the transaction process, available options may become significantly more limited.

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Common Mitigation Strategies

Potential mitigation approaches may include:

- Reasonable compensation analyses
- Shareholder approval processes for private companies
- Cutback provisions
- Compensation restructuring
- Payment timing adjustments
- Valuation support for restrictive covenants and non-compete arrangements
- Elimination or modification of tax gross-up provisions

The effectiveness of these strategies depends heavily on transaction structure, timing, documentation quality, and underlying compensation arrangements.

Reasonable Compensation Exception

Certain payments for services to be rendered after the transaction, or compensation that is otherwise demonstrated to be reasonable for services performed before the transaction, may be excluded from parachute payment treatment.

Reasonable compensation analyses often require detailed valuation support and contemporaneous documentation.

Authorities: IRC § 280G(b)(4); Treas. Reg. § 1.280G-1, Q/A-40 through Q/A-48.

Shareholder Approval (“280G Cleanse”)

Privately held corporations may be able to avoid parachute payment treatment if:

- Shareholders receive adequate disclosure of all material facts,
- Payments are approved by more than 75% of disinterested shareholders, and
- Affected individuals waive rights to payments unless shareholder approval is obtained.

Procedural compliance is critical for this exception.

Authorities: IRC § 280G(b)(5); Treas. Reg. § 1.280G-1, Q/A-6 through Q/A-7.

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Common Transaction Challenges

Companies and deal teams frequently encounter practical issues during the Section 280G analysis process, including:

- Tight diligence and transaction timelines
- Shareholder approval complexities in private company transactions
- Ambiguities surrounding contingent compensation treatment
- Coordination among legal, tax, payroll, valuation, and HR teams
- Equity-heavy compensation structures
- Low historical base compensation
- Multiple overlapping compensation arrangements
- Incomplete payroll or equity data

These issues often become more difficult and costly to address as transactions progress toward signing or closing.

Conclusion

Section 280G remains one of the most significant executive compensation considerations in CIC transactions. Early identification of potential exposure can help companies and transaction stakeholders preserve flexibility, improve decision-making, and reduce execution risk.

Given the technical and highly fact-dependent nature of the rules, proactive analysis and coordination across advisors are often critical to achieving an efficient transaction outcome.

ABOUT INFINITE EQUITY

Infinite Equity advises companies, boards, and transaction stakeholders on executive compensation, valuation, and CIC matters, including Section 280G analyses and mitigation strategies.

To discuss transaction-specific considerations or request a preliminary exposure assessment, contact the Infinite Equity team.

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