

Insights

SECTION 280G TAX CONSIDERATIONS IN M&A

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SUMMARY

If you're considering selling your company or its assets, there's a tax issue you need to know about: Section 280G of the Internal Revenue Code. Section 280G can have a significant impact on both the economics of a transaction and on certain service providers who may receive transaction-related compensation.

Because these rules can create significant tax consequences, early analysis is critical to understanding who may be impacted and how.

WHAT ARE "GOLDEN PARACHUTE PAYMENTS"?

Section 280G focuses on what are commonly referred to as "golden parachute payments." These are certain payments or benefits that may be triggered when a company goes through a change in control, such as a sale or merger.

These payments can result in significant tax consequences to both the company and the individual. As a result, identifying potential golden parachute payments and their consequences early in the transaction process is an important step in assessing overall deal economics and individual tax exposure.

WHAT ARE THE TAX CONSEQUENCES OF SECTION 280G?

Section 280G carries two primary tax consequences that can affect both the company and impacted individuals:

1. **Loss of corporate deduction.** The company loses its corporate tax deduction for the payments.
2. **20% excise tax to the recipient.** The recipient of a payment faces a 20% excise tax, in addition to regular income taxes. This excise tax applies to what are called "excess parachute payments."

Importantly, Section 280G does not apply to every transaction or to all service providers.

WHEN DOES SECTION 280G NOT APPLY?

Section 280G only applies to corporations. As a result, it does not apply to companies that are partnerships or S-corporations, or corporations that would qualify to elect to be an S-corporation. The rules treat certain commonly owned groups as a single entity, however, so care should be taken to review the entire group of companies involved in a proposed transaction.

TO WHOM DOES SECTION 280G APPLY?

For companies that are not exempt from Section 280G, the rules apply only to payments made to “disqualified individuals.” Section 280G could apply for payments to:

- **Corporate officers**, determined based on duties and authority rather than job title alone
- **The highest paid 1% of employees**, or
- **1% owners** of the company’s stock, including vested options

When evaluating potential Section 280G exposure, it is important to take a broad view of the types of payments or benefits that may be made because of a change in control. This can include acceleration of stock option vesting when the deal closes, transaction bonuses or severance entitlements, compensation increases or new agreements with the buyer, or anything granted in the twelve months before the transaction.

HOW IS IT DETERMINED IF THE TAX PENALTIES APPLY?

Application of the negative tax consequences comes down to a “three-times base amount test.” A disqualified individual’s average annual compensation over the prior five years is the base amount. If the total parachute payments for the individual equal or exceed three times that base amount, the excise tax applies on everything above one times the base amount.

These penalties can be avoided in some instances. For instance, privately held companies may be able to rely on a shareholder approval process to exempt certain payments from Section 280G. While public companies can’t use that shareholder approval process, there are still strategies to reduce the impact of Section 280G.

WHAT DO COMPANIES CONSIDERING A TRANSACTION NEED TO DO?

The Section 280G rules are nuanced and complex. Early planning and close consultation with counsel and tax advisors is crucial to identifying potential exposure and resolving any Section 280G issues. We have seen hundreds of transactions and are here to help with any questions you have about Section 280G.

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