

Compensation Packages: What's in Your Wallet? ¹

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I. Introduction

Since the 1940s, most businesses in the United States have used very similar compensation models. Most employees receive cash compensation as either salary or hourly wages, have sick and vacation leaves and a package of common fringe benefits that includes a retirement plan, medical plan and perhaps other plans such as dental or vision. The only change that occurred was employers before the mid-80s tended to offer a defined benefit pension plan as the retirement benefit. Since then, the typical retirement plan has become a 401(k) plan.

This compensation model became popular in the 1940s due to Congress' wage freezes enacted as a wartime measure. Congress adopted the 1939 Revenue Act that added an income tax exclusion for compensation from an accident or health insurance plan. In 1942, to finance the costs of the war, Congress enacted an 80% "excess profits tax" on business income and authorized the National War Labor Board to enact a wage freeze. Employers, scrambling to compete for labor, obtained a ruling from the Office of Price Administration that the wage freeze did not extend to fringe benefits. Instead, they started greatly expanding the level and types of benefits to attract desperately needed employees.²

This model worked well for the demographics and competitive situation at the time. However, today's economy and conditions are much different. Competitive pressures are greater, employees are more diverse, tenure is much shorter, and many of the benefits that started out as limited, minor cost items are now extremely expensive. These changes suggest that the traditional compensation model is due for an update.

A compensation program should offer the employer the following benefits:

- It allows the employer to distinguish itself from its competitors in attracting and retaining desired employees,
- It encourages (and rewards) higher levels of employee performance,
- It aligns employee performance with the employer's strategic goals,
- It minimizes cash outlays, accelerates deductions and defers income, and

¹ This memorandum contains a summary of information obtained from laws, regulations, court cases, administrative rulings and legal publications, and should not be viewed or relied upon as legal advice. Ater Wynne LLP urges readers of this memorandum to consult legal counsel regarding specific legal issues and factual circumstances.

² Employee Benefit Research Institute, History of Health Insurance Benefits, March 2002.

- It provides a higher perceived value to the employee than it costs the employer.

The Internal Revenue Code (“IRC”) is surprisingly flexible about compensation programs. Although it provides much guidance on how to treat various forms of compensation, the IRC does not prohibit any particular form or type of compensation. It may provide for a tax treatment that is prohibitively expensive, but Congress has left the selection of the amount and form of compensation to the employer. In considering how to structure a program that provides these benefits, it is useful to begin with a summary of how various forms of compensation are treated under the IRC for both the employer and the employee.

II. General Income Tax Rules

Ordinary income received by individuals is taxable at progressive rates ranging from 10% to 35%.³ Income received from an employer is presumed to be “wages” subject to employment taxes totaling 15.3% (paid in equal amounts by the employer and employee) on the first \$94,200 of wages and 1.45% on amounts above that level.⁴ Certain individuals may also be subject to alternative minimum income tax (“AMT”) designed to ensure that high-income taxpayers (those with “alternative minimum taxable income” above \$175,000 for married filing jointly taxpayers, or \$87,500 for single taxpayers) benefiting from certain tax deductions or credits pay at least a minimum amount of income tax.⁵ Current rates are either 26% or 28%.⁶ Long-term capital gains rates are 15% except for individuals in the two lowest marginal income tax ranges who pay 5%.⁷ Short-term capital gains (applied to assets sold within one year of acquisition) are taxed at ordinary income rates.⁸

Corporations also pay a progressive rate on ordinary income that ranges from 15% to 38%.⁹ Personal service corporations pay a flat rate of 35%.¹⁰ Corporate capital gains are taxed at corporate ordinary income tax rates, although gains and losses are netted before applying the tax.¹¹ Corporations are also subject to alternative minimum tax.¹²

III. Cash Compensation

For most employees, cash compensation such as salary, wages, or bonuses are the most common and most important form of compensation. Most employees see a wage statement every few weeks, if not more often, that remind them exactly how much their employer values their services. Cash bonuses may be awarded informally or under a formal program that might set out eligibility and funding requirements and allocation procedures or formulas.

³ Internal Revenue Code § 1.

⁴ IRC §§ 3101, 3111, 3121(a).

⁵ IRC § 55.

⁶ *Id.*

⁷ IRC § 1(h)(1).

⁸ *Id.*

⁹ IRC § 11(b).

¹⁰ *Id.* at (b)(2).

¹¹ IRC § 1201(a).

¹² IRC § 1201(a).

Cash payments from an employer to an employee are included in the employee's income when received or made available.¹³ Such payments are also subject at the time of payment to employment or income tax withholding as mentioned above. The employer receives a deduction for these payments when made, or for accrual taxpayers, when the employee performs the service.¹⁴ However, compensation above \$1 million per executive is not deductible by a publicly-traded corporation unless the excess compensation is subject to performance-based standards.¹⁵

Cash compensation is generally exempt from compliance with state or federal securities laws (other than possible disclosure required under securities rules) and ERISA. Cash payments or bonuses may discriminate between employees but do not provide an employee any ownership incentive, retirement security or tax advantage. Because cash is immediately available, employees can take it with them when they leave. Salaries and hourly wages motivate employees to show up but not necessarily be engaged in advancing the business' strategic interests. Additional issues relating to payment of cash compensation are discussed below.

A. Change in Control and "Golden Parachutes"

A "change in control" occurs when a new owner replaces the current owner of the controlling interest in a business. These provisions frequently call for post-severance payments of some multiple of annual salary, either as a lump sum or over time, and continuation of fringe benefits (such as health insurance) for a specified period at the employer's expense. Many executives have change in control provisions in their employment agreements since ownership changes frequently cause them to lose their position, as new owners often choose to bring in a new management team. Although not a retention or incentive tool, these provisions are a useful recruiting tool, especially for emerging businesses. The parachute payment rules discussed below may limit the amounts paid to a departing executive.

"Golden parachute payments" are compensation payments to "disqualified individuals" that are contingent upon a change in the ownership or effective control of a corporation (or its assets) that employs the individual. Generally, they exceed three times the individual's "base amount" of compensation over the previous five years.¹⁶ A parachute payment may also include compensatory payments that violate securities laws.¹⁷ "Disqualified individuals" are employees or independent contractors providing personal services that are also an officer, a 1% or more shareholder, or are "highly compensated."¹⁸ An individual is "highly compensated" if they are one of the highest paid 250 employees or, if lesser, the top one percent of all employees (independent contractors are treated as employees for these purposes).¹⁹

Any payments pursuant to an agreement made or amended within one year of the change in control are presumed to be contingent upon such change unless the taxpayer establishes

¹³ IRC § 451(a).

¹⁴ IRC §§ 162(a)(1), 461(h).

¹⁵ IRC § 162(m).

¹⁶ IRC § 280G(b)(2)(A), (b)(3)(a), (d)(1) and (d)(2).

¹⁷ IRC § 280G(b)(2)(B).

¹⁸ IRC § 280G(c).

¹⁹ *Id.*

otherwise with clear and convincing evidence.²⁰ Parachute payments include gains resulting from accelerating vesting on stock options upon the change and any other property transfers or payments.²¹ In general, the IRS treats a payment as contingent on a change in control if the payment would not have occurred absent a change in control even if the payment is also conditioned on the occurrence of another event. A payment is not treated as made in the absence of a change in control unless it is substantially certain, at the time of the change that the payment would have been made whether or not the change occurred. A payment that vests due to the change in control is not treated as a payment that was substantially certain to have been made whether or not the change occurred.²²

Parachute payments do not include payments to disqualified persons with respect to an S corporation, non-competition agreement payments or payments from corporations with stock that is not readily tradable and 75% of whose shareholders approve the payments following disclosure of all relevant facts.²³ Other exceptions include payments related to reasonable compensation for personal services rendered after the change in control and payments from qualified retirement plans.²⁴

If the change in control payments exceed the allowable amount, the payments that exceed the “base amount” are not deductible by the corporation but are included in the recipient’s income and are subject to a nondeductible 20% excise tax, for which the employer has withholding obligations.²⁵ Note that the excise tax applies to the payment amounts above the “base amount,” not just the excess over the three times base amount threshold. Therefore, it is critical to consider these limits in structuring change in control payments or the severance payments discussed below.

B. Severance Payments

Employers are not obligated to make severance payments absent an agreement or plan adopted by the employer. A written employment contract, an employee handbook, an established but undocumented practice, or an oral promise may establish the right to the severance. However, terminating an employee is never pleasant and often results in a lawsuit alleging discrimination, harassment, or other claims. For this reason, or to minimize the financial distress of the employee, many employers choose to make severance payments to employees terminating service for reasons other than misconduct.

Severance packages are not uniform. Many offer a continuation of pay and/or insurance benefits for a specified period, often tied to length of employment, outplacement services, or other benefits. They usually make the benefits contingent upon the former employee signing a release of claims against the employer.

²⁰ IRC § 280G(b)(2)(C).

²¹ IRC § 280G(d)(3).

²² Treas. Reg. 1.280G-1, Q-22.

²³ IRC § 280G(b)(5).

²⁴ IRC § 280G(b)(6).

²⁵ IRC §§ 280G(a), 4999(a) and (c)(1).

Until recently, severance payments were not really on the IRS watch list. By enacting IRC § 409A, Congress sought to comprehensively regulate “deferred compensation.” The treatment of severance or “separation pay” (as the IRS calls it) under these new deferred compensation rules illustrates the fundamental change that occurred. Previously, separation pay arrangements were not thought of as “deferred compensation.” However, the guidance issued by the IRS provides that separation pay may be subject to the deferred compensation rules depending on how it is structured.

1. Types of Severance Covered by IRC § 409A

The IRS guidance establishes the principle that a legally binding right to a payment that arises in one tax year and is paid in a future tax year creates deferred compensation. Such a payment is deferred compensation even if it is subject to a substantial risk of forfeiture, unless the payment is entirely within the discretion of the service recipient²⁶ (in which case there is no legally binding right). Accordingly, if an employer enters into a binding contract with an employee pursuant to which the employer makes a promise to pay certain amounts to the employee upon a termination of employment (or “separation from service” as IRC § 409A refers to it), the parties may have created a deferred compensation plan.

The general principle discussed above is distinguished from situations where the legally binding right to payment does not arise until the year in which payments are to be made. For example, upon termination of an employee, an employer offers the employee an immediate lump sum payment in exchange for a release of claims. Before the offer, the employer had no contractual severance obligation. As a result, there is no deferred compensation since the right to payment, the employee’s receipt of the payment, and taxation all occur in one taxable year.

The facts of each particular severance arrangement warrant close analysis in light of IRC § 409A. Fortunately the IRS and Treasury have provided some useful exceptions for certain types of severance arrangements and provided guidance on what type of severance is (and is not) subject to IRC § 409A.

2. Severance Arrangements Exempt from IRC § 409A

The IRS guidance exempts from IRC § 409A the following types of severance arrangements:

- Arrangements where the severance payments are made due to an *involuntary* termination or participation in a reduction-in-force window program (“RIF Program”) and do not exceed two times the lesser of (i) the employee’s annual compensation, or (ii) the limit on annual compensation for qualified plan purposes under IRC § 401(a)(17) (\$220,000 for 2006). Both the compensation and statutory limit amounts are based on the calendar year before the year in which the employee terminates employment. In addition, the employer must complete all severance payments by no later than the end of the second calendar year following the year in which the employee terminates employment.

²⁶ While IRC § 409A uses the term “service recipient”, this Memorandum uses the term “service recipient” and “employer” interchangeably, since the service recipient maintaining a severance arrangement is usually an employer.

- Reimbursement of expenses that are (i) otherwise excludible from the gross income of the employee, (ii) deductible by the employee under IRC §§ 162 or 167 as business expenses incurred in connection with the performance of services (ignoring any applicable limitation based on adjusted gross income), (iii) reasonable outplacement and moving expenses, and (iv) medical expenses, provided that the expenses are incurred and the reimbursements are made by no later than the end of the second calendar year following the year in which the employee terminates employment. This exemption applies to both cash and in-kind reimbursements.
- Severance arrangements pursuant to which the total payments do not exceed \$5,000 during any given taxable year.
- Collectively bargained separation pay arrangements that provide for payments upon an *involuntary* termination of employment or pursuant to a RIF Program.

The RIF Program exemption applies even though a termination may be voluntary based on incentives or otherwise. In order to meet the severance exemption from IRC § 409A, a RIF Program window period may not be more than a year and must specify the circumstances under which an employee must terminate in order to receive severance under the RIF Program.

The “short-term deferral”²⁷ exemption may also be available to severance payments, if (i) there is no binding contractual right to severance until the year of termination, (ii) the termination is involuntary or (iii) payments are completed within the short-term period. The exemption applies to compensation paid within 2½ months after the later of the calendar year or the employer’s fiscal year in which the payment is no longer subject to a substantial risk of forfeiture. The short-term deferral rule exemption is not available for “good reason” terminations.

3. Separation from Service or Termination of Employment

The IRS regulations provide that a “separation from service” (as IRC § 409A refers to it) occurs when the employee dies, retires, or otherwise has a termination of employment from the employer. However, the employment relationship continues while the individual is on military leave, sick leave, or other bona fide leave of absence if the period of leave does not exceed six months, or if longer, while either a statute or contract mandates the individual’s right to reemployment with the employer. In the absence of a statutory or contractual right to reemployment, the employment relationship terminates and a separation from service occurs on the first date immediately following such six-month period.

Whether the employee has experienced a termination of employment is determined based on the relevant facts and circumstances. The proposed IRS regulations provide specific guidance aimed at curbing abusive practices to avoid sham arrangements by which payments can either be accelerated or delayed in violation of the time and form of payment rules under IRC § 409A.

If the employer wants an employee to continue providing services after the former employment relationship has ended and that will further delay payment and taxation, a termination of

²⁷ The short-term deferral rule provides that payments made within 2½ months of the close of the later of the calendar or fiscal year in which the right to a payment is earned are generally exempt from IRC § 409A.

employment occurs if the employee is providing only “insignificant services.” An employee provides “significant services” if the employee works at least 20% percent or more of the time he or she worked prior to termination and is paid 20% percent or more of his or her pay after the so-called termination of employment. The 20% time and pay threshold is based on a three-year average for the three years immediately before the year in which the termination occurs (or, the employee’s tenure if the employee was employed for less than three years).

If a former employee continues to provide services to a former employer other than as an employee, the proposed IRS regulations provide that no termination occurs if the former employee continues to work and receive payment of at least 50% or more of their pre-termination levels. Similar to the 20% threshold discussed above, the 50% time and pay threshold is based on a three-year average for the three years immediately preceding the year in which the termination occurs (or, if the employee was employed for less than three years, such lesser period).

The “same desk rule” does not apply to the IRC § 409A concept of “separation from service.” A sale of substantially all of an employer’s assets will generally trigger a termination of employment even if the purchaser employs the recipient. Such circumstances will generally require payment (or the start of payment) of severance amounts scheduled for payment upon termination of employment.

4. Severance Payments to Key Employees

For “key employees” of public companies (or certain affiliates), severance payments that do not meet an exemption from IRC § 409A, like all other forms of deferred compensation, are subject to a six month payment delay requirement. A key employee is determined in accordance with the top-heavy testing rules applicable to qualified retirement plans, with minor changes.²⁸

C. Bonus or Incentive Compensation

The declining stock market and new accounting rules that magnify the cost of stock options has caused many employers to consider other forms of incentive compensation. Bonuses and incentive pay are well suited to align an employee’s personal interests with the employer’s interests.

To be effective, such programs must successfully tie job performance to the employer’s success. Begin with information meaningful to the employee. Employers also need to decide whether to base the incentive on individual, group, or company performance. A multi-tiered design is usually best, since individual-only plans do not encourage cooperation or assistance and company-wide plans may not be specific enough. Different levels of employees get different mixes of the three elements. A CEO incentive should be based 100% on company performance. Managers might be 50% company and 50% team, while a receptionist might be 80% individual and 20% company, and a salesperson 100% individual. Weighting the incentive depends on the

²⁸ Unlike qualified plans, the employer sets an identification date for determining the key employees and anyone that is a key employee on that date is a key employee for the 12-month period starting on the first day of the 4th month after that date. For example, a key employee on an identification date of December 31 is a key employee for a 12-month period starting the next April 1.

relative importance of individual, team, and company results. The critical issues are (i) what an employer measures and pays for is what it will get, and (ii) continuous communication.

IRC § 409A applies to bonuses that are paid in the year following the year in which the services giving rise to the bonus are performed unless the “short-term deferral” exception applies. However, the bonus payment may be made after the 2½ month, short-term deferral period without incurring a violation of IRC § 409A if it is administratively or economically impracticable to make the payment within the 2½ month period, or if making the payment within the 2½ month period would jeopardize the solvency of the employer, the impracticability or insolvency was unforeseeable, and the payment is made as soon as reasonably practicable. Counsel should always be consulted prior to delaying any payment, including a bonus, to an employee without the employee’s consent, as the delay in payment may likely violate IRC § 409A or state wage and hour statutes.

EXAMPLE: An employee earns a bonus payable by March 15, 2007, based on services performed during 2005 and 2006. If the bonus is never subject to a substantial risk of forfeiture, then the bonus is subject to IRC § 409A. If the same bonus is payable only if the employee is employed on December 31, 2006 (a substantial risk of forfeiture), then the bonus is not subject to IRC § 409A, because it will be paid within 2½ months after the year in which the employee became vested in the bonus due to being employed on December 31, 2006.

Bonus programs that are subject to IRC § 409A must be in writing. Except for bonuses that are entirely discretionary, state wage and hour laws may also require that bonus programs be in writing. In addition, under IRS transition rules, employers only have until December 31, 2006, to document their unwritten bonus programs that are subject to IRC § 409A. Because the IRC § 409A penalties are so harsh, employers would be well advised to document and operate their bonus programs in compliance with IRC § 409A and state law. If the employer also maintains other “account balance” deferred compensation plans, a violation of the IRC § 409A rules with respect to one bonus payment for the participant will expose all of that participant’s other vested account balance deferred compensation to IRC § 409A taxation.

Generally, under IRC § 409A rules, a participant must defer compensation before the first day of the calendar year during which the participant will perform the services giving rise to the compensation. Another exception to IRC § 409A is a rule for performance-based compensation. A participant may elect to defer performance-based compensation as late as six months prior to the end of the performance period, even if it covers more than one year. Such an election can be made only if at the time of the deferral election, the amount of compensation is not readily ascertainable or the right to receive the promised amount of compensation is not substantially certain.

To qualify as performance-based compensation, the compensation must arise from the participant’s satisfaction of pre-established criteria over a performance period of at least 12 consecutive months. The employer may base the pre-established criteria on either organizational or individual performance criteria. The criteria must be established no later than 90 days after the beginning of the performance period. If it is substantially certain that the performance

criteria will be met at the time the criteria are established, then the compensation does not qualify as performance-based compensation.

The performance criteria may be subjective only if they relate to the performance of the participant, a group that includes the participant, or the participant's business unit. Neither the participant nor a family member can make the determination that the participant has satisfied the subjective criteria. Someone under the supervision of, or whose compensation is controlled in any part by, the participant or a family member of the participant is also ineligible to make the determination.

Compensation is performance-based even if the compensation is based solely on the increase in the value of the service recipient's stock. To qualify as performance-based compensation, however, the compensation must be based solely on an increase in the value of the stock after the date of the grant or award. For example, the stock right cannot have been granted with an exercise price of less than the stock's fair market value on the date of the grant, unless the compensation is subject to a performance-based vesting condition.

IV. Equity-Based Compensation

In addition to cash payments, many employers utilize equity-based compensation. For emerging businesses, using equity allows the business to conserve cash needed to develop the business, its products and infrastructure. Because the equity mirrors the owners' interests, it also aligns the recipient's interests with the owners.

There are valid business reasons why an award should be paid solely in cash, solely in equity, or a combination. Additional reasons exist for making awards vest or exercisable only after attainment of performance objectives or the passage of time. The first question the employer should ask is whether its intention is to provide the recipient with appreciation in the value of its stock or the value of the underlying stock. The answer to this question, in turn, is heavily dependent on whether the employer's objective is incentive or retentive. These factors weigh on the employer's fundamental consideration in awarding any form of compensation.

Awards that provide appreciation in the equity of the employer from a certain point forward are generally limited to incentive awards and provide little retentive effect. When such awards are made annually and attached to a vesting schedule, the retentive effect is increased, but only if the stock is appreciating. A fluctuating or declining stock price will greatly reduce or eliminate the value to the employee.

EXAMPLE: An employer awards annual stock options that vest over five years. The exercise prices of the options are \$20, \$25, \$30, and \$35. At the end of year four, the stock price is \$40. The options have significant value and are not fully vested, giving the recipient significant incentive to stay. If the stock price had fluctuated, so the exercise prices were \$20, \$30, \$40, and \$45, the retention value is significantly reduced. If the stock value has declined, the options have no value and there is no retention benefit to the employer.

An award of the stock itself will have a much larger retentive effect regardless of the stock price. If an employer awards 1,000 restricted shares when the stock is worth \$50 a share, the value to

the employee is \$50,000. If the stock appreciates to \$60 a share, the value increases to \$60,000. Even if the stock drops to \$30 a share, the recipient still has \$30,000 in value. If this award is subject to a vesting schedule, the recipient at all times has a significant amount at risk if they choose to terminate services.

Employers use these arrangements to provide performance or retention incentives to selected employees. The employer can structure the compensation to defer immediate income taxation of the incentive, to forfeit the incentive if the employee leaves the company, to reward past performance or reward future growth of the company. The reduced capital gains tax rate, a shorter capital gains holding period, possibly avoiding FICA/FUTA tax, and an employee demand to share in the growth of the employer are all reasons to consider these options. Equity-based plans are divided into three groups: outright grants or sales of stock, options on stock, or derivatives of stock or options.

A. Stock Sales, Grants or Awards

An outright grant of stock is taxable as wages equal to the fair market value of the stock on the grant date.²⁹ Most employers choose to place restrictions on the stock, such as the recipient forfeits the previously-awarded stock if they terminate employment before a certain number of years, or it is repurchased at that time for a previously-established price. If the stock is subject to a substantial risk of forfeiture, the taxation is delayed until the risk of forfeiture lapses.³⁰ If the stock is sold to an employee or service provider, the taxable amount is the excess of fair market value over the purchase price.³¹ The corporation can deduct the amount included in the recipient's income on the earlier of the date the shares become nonforfeitable, the date the recipient makes an "83(b) election,"³² or the date the corporation cancels the restriction on the stock.³³ Employers have an employment and income tax withholding obligation as of this date.³⁴

Stock, either restricted or not, is often used for bonuses. Its taxation is identical to that discussed above. In other words, the purpose of awarding the stock is not relevant to its treatment, which depends on the presence or absence of restrictions and whether the stock is taxed upon grant or a later date.

The holder of stock, whether restricted or not, enjoys benefits of ownership including dividend rights, voting rights, and potential appreciation despite not being taxed on the value of the shares (or their excess over the purchase price) until the restrictions lapse or the conditions are fulfilled. If the fair market value of the stock declines, the stock still has value, unlike options that can offer no value to employees.

²⁹ IRC §§ 83(a), 3121(a).

³⁰ IRC § 83(a); Treas. Reg. 1.83-3(c)(1).

³¹ *Id.*

³² IRC § 83(b) allows a recipient of restricted stock to accelerate its income tax recognition to the grant date.

³³ Treas. Reg. 1.83-6(a).

³⁴ *Id.*

B. Stock Options

A stock option is the right to purchase stock at a predetermined price for a specified period. The purchase price is usually fixed on the date the option is granted, allowing the recipient to purchase stock at the same price throughout the option period. If the value of the stock increases during that period, the option provides value to the recipient. Options are either “qualified” or “nonqualified.”

1. Qualified Options

Qualified options, also known as incentive stock options or ISOs, provide some unusual tax benefits to recipients. Only current employees can receive ISOs. The employer must award them under a plan approved by its shareholders that specifies the number of options available, employee eligibility requirements and certain limitations for specified employees.³⁵ The option cannot have a term longer than ten years (five years for 10% shareholders), have an exercise price at least equal to the fair market value of the underlying stock on the grant date, and are limited to the first \$100,000 that become exercisable in any year.³⁶ Additional restrictions apply.

Qualified options are not taxable at grant or upon exercise. Instead, the option is taxed upon sale of the stock acquired from exercising the option. This may allow an employee to receive capital gains treatment for the sales proceeds if the sale occurs at least two years after grant and one year after exercise,³⁷ however, the employee may have alternative minimum tax in the year of exercise.³⁸ If the sale occurs before the one- or two-year periods expire (a “disqualifying disposition”), the employee is subject to ordinary income tax in the year of the sale. The corporation is not entitled to a deduction for ISOs unless a disqualifying disposition occurs. The employer may deduct the amount considered as ordinary income by the employee. No withholding is required, since the exercise of the ISO is not “wages” for these purposes.³⁹ However, the employer does have a reporting obligation to the participant under IRC § 6039(a).

2. Non-Qualified Options

Non-qualified options (NSOs) are any options that do not meet the ISO requirements above. For example, an employer wanting to compensate a Director for serving on its Board could not use ISOs since the Director is not an employee. However, the employer can award NSOs to non-employees that have the exact same provisions and economic benefits as an ISO.

Because NSOs do not meet the ISO requirements, tax treatment is slightly less favorable. NSOs are taxable upon exercise.⁴⁰ The taxable amount is the difference between the fair market value of the stock received and the exercise price. This amount is taxed as wages to the employee, is deductible by the employer, and triggers employment tax payment and withholding

³⁵ For example, certain employees cannot be awarded options with an exercise price below 110% of fair market value on the grant date.

³⁶ IRC § 422; Notice 87-49.

³⁷ IRC § 421(a)(1).

³⁸ IRC § 56(b)(3).

³⁹ IRC §§ 421(b), 3121(a)(22), 3231(e)(12).

⁴⁰ IRC § 83(a), Treas. Reg. 1.83-7(a).

obligations.⁴¹ The stock received upon exercise of the option is not taxable until its eventual sale. Assuming the stock is held for the capital gains holding period after exercise, it will qualify for capital gains rates.

3. Performance-Based Vesting and Hurdle Rates

Like cash awards, both ISOs and NSOs can vest immediately, over a specified period of continuous employment or based on performance. For example, an employer may provide an option to acquire 100 shares of its stock to an employee if net income exceeds a specified threshold before a certain date. If the contingency is satisfied, the option vests. Otherwise, the option is forfeited, and the employee is never given the chance to exercise. Employers may exercise great creativity in the conditions they impose for vesting. Different levels of employees may have different criteria, depending on their role with the employer. In addition, multiple triggers may be used, such as a performance-based target and an ongoing employment condition.

Another twist is to gradually increase the option exercise price over the life of the option to account for inflation and require the recipient to provide a better than risk-free return to the shareholders. The “hurdles” for the recipient (the exercise price) get higher over time.

C. Equity Derivatives

Some compensation programs involve instruments that are neither a share of stock nor an option to acquire one, but rather capture value from one or the other. The names and types of these equity compensation arrangements are nearly limitless. However, they fall into two general groups: those that provide the recipient with value based upon the appreciation of the employer’s stock between two points in time, or those that provide the recipient with the underlying value of the stock at a fixed point in time. The variances may simply provide different tax, accounting, or securities law consequences. Some more common tools and their tax impacts are discussed below.

1. Appreciation-Based Instruments

The most common of these is a stock appreciation right (SAR) which itself has many varieties. Generally, a SAR is a right to be paid an amount equal to the difference between the fair market value of the employer’s stock on the date the SAR is awarded and the date the SAR is exercised. They are attractive because they enable an employee to secure an equity interest in the employer without a cash investment. The shareholders like them because it may not cause a dilution of ownership interests if the SAR is settled in cash. SARs frequently have vesting or performance-related conditions attached to them and may be settled in cash or stock of the employer. Economically, they work like an option but do not require the employee to pay anything and may not result in ownership. SARs generally do not include the right to dividends payable on the underlying stock.

Granting a SAR is not a taxable event. Upon exercise, the cash or stock paid to the recipient (equal to the appreciation in the value of the employer’s stock since the grant date times the number of SARs awarded) is ordinary income to the employee and deductible by the employer.

⁴¹ See Rev. Rulings 79-305, 78-185, 67-257.

If the SAR is contingent upon a change of control, it may be considered a parachute payment. For FICA and FUTA purposes, an employee is considered to have “wages” upon exercise of the SAR.⁴²

As mentioned above, the typical reason for offering a SAR instead of an option with cashless exercise features is the SAR does not require settlement with an ownership interest. Closely-held family businesses that do not want to give up control but want to provide incentives to non-family management employees find them useful. In addition, publicly-traded employers that are subject to Sarbanes-Oxley have prohibited loan concerns on cashless exercise stock options. Finally, SARs require the employer to purchase or issue fewer shares to settle the SAR than an equivalent option.

2. Stock-Based Instruments

Unlike the appreciation-based instruments, stock-based derivatives transfer immediate value that exists regardless of whether the stock price moves up, down, or sideways. The most common forms of this instrument are phantom stock, restricted stock units, or deferred stock. These look and act like restricted stock, except actual shares are not awarded upon grant. Instead, shares are issued when the vesting date occurs or the performance criteria are satisfied (or the later of both). The award may be paid in cash, stock, or a combination. Partial cash payments are common to accommodate tax withholding.

These awards have good retentive properties because of the inherent value existing on the grant date. However, these awards usually do not give the recipients the right to vote or dividends, and the unsecured promise to deliver value in the future is different from holding actual shares of stock. For most companies, these are not issues, since they do not pay dividends and voting an actual award of 20,000 shares may not mean much if there are a million outstanding. Differences between these awards include the form of payment and potentially different income tax, securities, and accounting consequences.

Under these arrangements, the employer awards a hypothetical number of shares of stock to the recipient. The phantom interests are credited to the recipient’s account, as are all dividends, stock splits, or other similar events. At some point in the future, the recipient becomes entitled to receive an amount of cash or actual stock equal to the account balance. These payments are subject to employment tax and withholding and are deductible by the employer.⁴³ Awards usually require some performance or other vesting requirement. A common vesting event is a change of control, allowing the recipient to share in the sales proceeds paid to the “real” owners of the company.

Again, these types of plans are used to allow recipients to receive the economic benefits of company ownership without the voting or other rights associated with actual stock ownership. They work well at retaining executives and, when combined with performance standards, provide very good incentives with no cash outlay by the recipient.

⁴² IRC §§ 3121(v)(2), 3306(r)(2).

⁴³ IRC §§ 83(a), 3121(v)(2), 3306(r)(2) and 162(a).

V. Deferred Compensation

Any of the above methods can trigger the application of the punitive provisions of IRC § 409A. IRC § 409A governs arrangements that provide for the deferral of compensation to “service providers” such as employees, directors, or independent contractors. IRC § 409A generally applies to amounts deferred after December 31, 2004, under a “deferred compensation plan,” defined as any plan that provides for the deferral of compensation, other than tax-qualified plans and bona fide vacation leave, sick leave, compensatory time, disability pay, and death benefit plans.

A. Deferred Compensation

The IRS’ guidance states that a plan provides for the “deferral of compensation” only if, under the terms of the plan and the relevant facts and circumstances:

The service provider has a “legally binding right” during a taxable year to compensation that has not been actually or constructively received and included in gross income, and

Pursuant to the terms of the plan, the compensation is payable to (or on behalf of) the service provider in a later year.

A legally binding right to compensation exists even if the right is subject to a substantial risk of forfeiture. An example is an employee that in year 1 is promised a bonus equal to a set percentage of employer profits, to be paid out in year 3 if the employee is still employed through year 3. The employee has a legally binding right to the compensation in year 1, but it is subject to a vesting condition—*i.e.*, that he or she remain employed through the last day of year 3 in order to be paid. In contrast, an employee does not have a legally binding right to compensation if that compensation may be unilaterally reduced or eliminated at the employer’s discretion after services have been performed. However, if the surrounding facts and circumstances indicate that the discretion “lacks substantive significance,” or is available or exercisable only upon a condition, the employee is nevertheless treated as having a legally binding right to the compensation.

B. Deferred Compensation Plan

A “nonqualified deferred compensation plan” includes “any agreement, method or arrangement, including an agreement, method, or arrangement that applies to one person or individual” that provides for the deferral of compensation. This definition is not limited to arrangements between an employer and an employee, and instead may apply to “arrangements between a service recipient and an independent contractor, or arrangements between a partner and a partnership.” Independent contractors and partners can meet exceptions or safe harbors.

The plan must be in writing. Compliance with this documentary requirement has been delayed until the end of 2006 under a transition rule. Generally, a participant’s rights will be determined based upon the provisions applicable under a particular arrangement, as evidenced by a plan document. Where the terms of a plan or arrangement comply with IRC § 409A, but the plan sponsor does not follow the plan’s terms, a violation might nevertheless result.

EXAMPLE: A plan document provides for installment payments upon a separation from service, but participants in the arrangement are repeatedly offered the opportunity to receive a lump sum payment. The facts and circumstances in this instance may indicate that the arrangement provides for an election of a lump sum payment for all participants in violation of IRC § 409A election-timing rules.

The definitions of “deferred compensation” and “deferred compensation plan” make sense when viewed in light of Congress’ goal, which is to prevent taxpayers from postponing taxation on compensation that was “deferred” while retaining broad discretion respecting the form or timing of payments.

Despite the broad definition of “deferred compensation” or “deferred compensation plan,” there are some important exceptions available that allow compensation packages to avoid the IRC § 409A requirements. They include the following:

C. Short-term Deferral Exception

A deferral of compensation does not occur if (absent an election to otherwise defer the payment to a later period), at all times, the terms of the plan require payment before the later of 2½ months from the end of the employee’s or employer’s taxable year in which the amount is no longer subject to a substantial risk of forfeiture.

Where an amount is never subject to a substantial risk of forfeiture, it is considered no longer subject to a substantial risk of forfeiture on the date that the employee first has a legally binding right to the amount. Under this rule, multi-year bonus arrangements that require payments immediately after the amount vests would generally be exempt from the reach of IRC § 409A.

D. Certain Stock Options and Stock Appreciation Rights

Nonqualified and incentive stock options and stock appreciation rights (SARs) are generally exempt from IRC § 409A if (i) the exercise price is never less than the fair market value of the underlying stock on the grant date, and (ii) the employee cannot defer the taxable income under the option or SAR beyond the exercise date (i.e., there is no “additional deferral feature”). SARs must also limit the compensation payable upon exercise to the difference between the fair market values on grant and exercise dates times the number of shares fixed on the grant date. SARs are eligible for this exemption regardless of whether the employer is public or private and whether the employer settles the SAR in cash or employer stock. However, the valuation method used to establish the option’s or SAR’s value on the grant and exercise dates becomes critical, since an inaccurate valuation causes the option or SAR to lose its exemption.

1. Common Stock Only

The stock underlying an exempt stock option or SAR must be publicly-traded common stock of the employer or, if the company is private, the common stock that represents the highest-value class of outstanding common stock of the employer without regard to voting rights. The stock may not be subject to any preferences as to dividends or liquidation rights, non-lapse put or call rights, or mandatory repurchase obligations based on a value other than the fair market value of the stock. American depository receipts relating to such employer stock will also qualify as

employer stock for purposes of the exemption. Accordingly, options or SARs on either preferred stock or a separate class of common stock that includes preferences are not exempt from IRC § 409A to the extent used for employee compensation.

2. When Parent Company Stock Is Allowed

Stock options and SARs covering common stock of a parent corporation can qualify as employer stock with employees of a subsidiary provided the parent owns at least 50% of the fair market value or voting power of the subsidiary's outstanding stock. In limited circumstances, the ownership interest can be as low as 20%. For example, stock of a corporation owning only 20% of a joint venture with an operating business may constitute employer stock if used for grants to former employees of the corporation now employed by the venture. To prevent abuse, the proposed regulations provide that stock of a corporation that serves primarily as an investment vehicle will not qualify as employer stock except for its direct employees.

3. How to Value Private Company Stock

The key requirement for an option or SAR to be exempt from IRC § 409A is that the option or SAR must have an exercise price no greater than the fair market value of the employer stock on the grant date (and a SAR must use fair market value on the exercise date). The IRS has proposed detailed provisions with respect to the valuation of privately held employer stock. The guidance provides that the factors considered in valuing private company stock include asset values, future cash flows, objectively determined values of similar entities, control premiums or discounts for lack of marketability, and whether the valuation method is used for other material purposes. The guidance allows any "reasonable" valuation method, but a valuation method will not be deemed reasonable unless all material available information is considered.

The following valuation methods are presumed to result in a reasonable valuation, unless use of such method was "grossly unreasonable" under the circumstances:

an independent appraisal that complies with rules set forth in the Code for employee stock ownership plan valuations, provided the value is measured not more than 12 months before the relevant grant date;

a valuation formula that governs the subsequent transfer of any shares, and is used for all compensatory and non-compensatory valuations of the stock, including regulatory filings, loan covenants, and transactions involving the issuance or repurchase of the stock (temporary valuation formulas or temporary restrictions on stock values, or "lapse restrictions," may not be considered under this method);
or

For certain start-up companies, a written valuation report that considers the valuation factors listed above and is prepared by a person with "significant knowledge and experience or training in performing similar valuations." This valuation method can only be used for stock issued by a non-public corporation that has been in business for less than 10 years. Furthermore, the stock must be illiquid and not subject to any non-lapse put or call right or obligation (other than

a right of first refusal). This method is not available if a change in control or IPO is reasonably anticipated within the next 12 months.

4. Put and Call Rights

The IRS was concerned that put or call rights on stock received pursuant to the exercise of options or SARs could be used to circumvent IRC § 409A. For example, if an employee exercises an option having an exercise price equal to fair market value, but the employer then purchases the shares at a price *greater than* fair market value, the effect would be the same as if the option exercise price were below fair market value. Because of this issue, the IRS requires that any nonlapse put or call rights be set at the fair market value of the shares at the time of purchase. Because this rule disregards lapse restrictions, it would allow stock to be repurchased for a price lower than fair market value if, for example, an employee resigned or was terminated without cause before a specified time.

5. Modifications and Renewals of Outstanding Stock Rights

Certain modifications to an existing stock option or SAR exempt from 409A can cause the option or SAR to become subject to IRC § 409A. If an option is modified by making a direct or indirect reduction to the exercise price, the modification will be treated as a new grant. The option, therefore, will become subject to IRC § 409A if the grant has a discounted exercise price at the time of such modification to the exercise price. Adding an additional deferral feature means it will not be exempt from IRC § 409A, regardless of the exercise price.

By contrast, if an option is modified by extending the exercise period, the modification is *not* treated as a new grant. Instead, the option is deemed to have had an additional deferral feature as of the original date the option was granted and, therefore, is retroactively subject to IRC § 409A as of the original grant date. Note that this rule would seem to apply to "underwater" grants, which previously had been assumed unaffected by IRC § 409A on an extension of time to exercise. (Certain extensions of the exercise date upon a termination of employment are permitted, as discussed below.)

An inadvertent modification to an outstanding stock option or SAR that would otherwise trigger the application of IRC § 409A to that grant can be rescinded, provided such rescission occurs prior to the earlier of (i) the date the modified grant is exercised, or (ii) the last day of the calendar year in which the modification occurs.

The following changes to an existing grant will not be treated as a modification:

the acceleration of the exercise date,

the cash-out of the grant for an amount equal to that otherwise payable upon exercise (a helpful rule in the context of mergers and acquisitions),

the addition of a right to deliver previously-acquired shares in payment of the exercise price, and

the addition of rights to facilitate the payment of employment taxes or required withholding taxes arising on exercise.

Although the repricing of an outstanding option or SAR will be treated as a new grant, the new grant may continue to qualify for the exemption if that grant does not have a discounted exercise price. However, multiple repricings of the same option or SAR may be viewed as evidence that the exercise price is adjustable, causing the option or SAR to not qualify for the IRC § 409A exemption from the date of the original grant.

As noted above, an extension of the period for which an option or SAR is exercisable will result in the loss of the IRC § 409A exemption, retroactive to the original grant date. An extension of the period during which an option may be exercised following termination of employment is permitted, however, if the exercise period is not extended beyond the later of (i) the end of the calendar year in which the grant would otherwise have expired, or (ii) the 15th day of the third month following such expiration date.

E. Restricted Stock

The issuance of restricted stock remains outside the scope of IRC § 409A, regardless of whether the recipient makes a Section 83(b) election with respect to that stock.

F. Restricted Stock Units/Deferred Compensation Units

Restricted stock units and other deferred compensation units generally must be structured to comply with IRC § 409A. For many employers, restricted stock units are settled by issuing stock a short time after the units vest. Such units will not be subject to IRC § 409A if settled (whether in stock or cash) before the later of (i) two and one-half months after the end of the employer's fiscal year in which vesting occurred, or (ii) March 15 following the calendar year in which vesting occurred. If the units qualify as performance-based compensation under IRC § 409A (as discussed below), the holder may make an initial deferral election at any time prior to the last six months of the performance vesting period.

G. Performance-Based Pay

IRC § 409A provides that in the case of any performance-based compensation linked to services performed over a period of at least 12 months, a participant's initial deferral election may be made no later than 6 months before the end of the period. Performance-based compensation is defined as compensation that is contingent on the satisfaction of pre-established organizational or individual performance goals. The performance criteria may be established up to 90 days after the commencement of the period of service to which the criteria relate, if the outcome is not substantially certain at the time the criteria are established.

Performance-based compensation may be based solely on an increase in the value of the employer, or the stock of the employer, after the date of grant or award. Under this rule, a SAR could typically qualify as performance-based pay, because the employee can only receive payment for any increase in the stock value. Note, however, that if an SAR allows deferral of income beyond the exercise of the SAR, then the SAR does not qualify for exemption from 409A.

By contrast, under a restricted stock unit ("RSU") program, the employee is typically entitled to some payment regardless of whether there is an increase in the stock value. Thus, unless vesting in such an RSU is performance-based, the RSU would not be considered performance-based pay.

For those SARs subject to IRC § 409A and for restricted stock units, the timing and form of the payout must generally be specified as of the date of the grant. However, for payments (including SARs and RSUs) that are not vested when granted, a later election may be allowed. If such a payment would otherwise be made by March 15 of the year after the payment vests, then the employee is allowed to elect to defer such payment. The election must be made at least 12 months before the payment vests and must defer the payment until at least five years after the payment vests.

Under a separate rule, an employee may elect to defer a non-vested award within the first 30 days of its grant, if the award requires at least 12 months of additional service after the grant date for vesting, and the election is made at least 12 months before the vesting date. Under this rule, the election need not defer the payment five years.

H. Independent Contractors and Directors

IRC § 409A generally excludes from coverage under IRC § 409A amounts deferred pursuant to an arrangement between an employer and an unrelated independent contractor (other than a director of a corporation), if the independent contractor is providing significant services to two or more unrelated employers. Determining whether services are "significant" involves an examination of all relevant facts and circumstances. The proposed rule adds a safe harbor under which an independent contractor will be treated as providing significant services to more than one service recipient, so long as no more than 70% of the service provider's annual revenues are derived from any one particular employer (or controlled group of entities that include the employer).

IRC § 409A covers directors, but the plan aggregation rules are applied separately to arrangements between directors and each company. Thus, for example, a violation of an arrangement covering an individual who is a director of Company A would not result in a violation of an arrangement covering the same individual in his or her capacity as a director of unrelated Company B.

I. Separation Pay Exceptions

Collectively bargained severance arrangements that pay benefits in the case of an involuntary termination of employment, or a voluntary separation under a "window plan," are exempt from the reach of IRC § 409A. Non-collectively bargained severance arrangements that pay benefits in the case of an involuntary termination of employment, or a voluntary separation under a window plan, are exempt from the reach of IRC § 409A if the amount of the benefit is no more than the lesser of (i) twice the employee's annual compensation, or (ii) twice the annual IRC § 401(a)(17) qualified plan compensation limit (\$220,000 in 2006), and the benefit is paid no later than the close of the second year following the year in which termination occurs. Certain reimbursement arrangements upon separation are exempted from the requirements of IRC § 409A. Examples include outplacement services, medical, dental, or other fringe benefits, or relocation expenses.

J. Foreign Plans

IRC § 409A is not limited to U.S. income. Since U.S. citizens and resident aliens are generally subject to U.S. income tax on their worldwide earnings (unless exempted by treaty), the Act's provisions could potentially sweep in a great deal of income that Congress never intended to reach. The proposed rule provides some important exemptions and safe harbors intended to accommodate the reasonable concerns of service providers with foreign employment or foreign deferred compensation.

VI. Conclusion

Compensation design is a critical yet often overlooked strategic business decision. Too often, compensation packages are designed based on tradition, common practices or other factors that do not consider the contribution expected of the employee, the business' strategic goals and linking compensation to the individual's contribution to the success of the company. The proper application of the right tools and design can allow employers to achieve better results and actually cost less than a traditional compensation package.