PRESENT LAW AND BACKGROUND RELATING TO EXECUTIVE COMPENSATION

Scheduled for a Hearing
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INTRODUCTION

The Senate Committee on Finance has scheduled a hearing for April 18, 2002, on issues related to corporate governance and executive compensation. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present law relating to certain types of executive compensation arrangements, including nonqualified deferred compensation, split-dollar life insurance, the $1 million dollar cap on the deduction for executive compensation, golden parachutes, corporate-owned life insurance ("COLI"), and stock-based compensation. This document also includes a general discussion of issues relating to nonqualified deferred compensation arrangements.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Relating to Executive Compensation* (JCX-29-02), April 17, 2002.

I. NONQUALIFIED DEFERRED COMPENSATION

A. General Description

1. General definition

Deferred compensation occurs when the payment of compensation is deferred for more than a short period after the compensation is earned (i.e., the time when the services giving rise to the compensation are performed). Payment is generally deferred until some specified event, such as the individual's retirement, death, disability, or other termination of services, or until a specified time in the future, such as five or ten years.

The Internal Revenue Code (the "Code") provides tax-favored treatment for certain types of employer-sponsored deferred compensation arrangements that are designed primarily to provide employees with retirement income. These arrangements include qualified defined contribution and defined benefit pension plans (sec. 401(a)), qualified annuities (sec. 403(a)), tax-sheltered annuities (sec. 403(b)), savings incentive match plans for employees or "SIMPLE" plans (sec. 408(p)), and simplified employee pensions or "SEPs" (sec. 408(k)). For simplicity, these plans are referred to collectively here as "qualified employer plans." A nonqualified deferred compensation arrangement is any deferred compensation arrangement that is not one of these qualified employer plans.[2]

2. Types of nonqualified deferred compensation arrangements

(a) In general

Nonqualified deferred compensation arrangements are contractual arrangements between the employer and the employee, or employees, covered by the arrangement. Such arrangements are structured in whatever form achieves the goals of the parties; as a result, they vary greatly in design. Considerations that may affect the structure of the arrangement are the current and future income needs of the employee, the desired tax treatment of deferred amounts, and the desire for assurance that deferred amounts will in fact be paid.

In the simplest form, a nonqualified deferred compensation arrangement is merely an unsecured, unfunded promise to pay a stated dollar amount at some point in the future. However, in most cases, such a simple arrangement does not meet the needs of the parties to the arrangement; thus, the typical nonqualified defined compensation arrangement is more

[2] An eligible deferred compensation plan (sec. 457(b)) is a nonqualified deferred compensation arrangement that is maintained by a tax-exempt or a State or local government employer and that meets certain requirements. An eligible deferred compensation plan of a State or local governmental employer generally receives tax-favored treatment under the Code similar to qualified employer plans. Eligible deferred compensation plans of tax-exempt employers are discussed more fully in Part A.3, below.

complicated and may involve a funding vehicle or other mechanism to provide security to the employee.[3]

(b) Possible structures

Some nonqualified deferred compensation arrangements are structured as formal plans with formal governing documents. In such cases, the plan generally specifies the employees covered by the plan. In other cases, nonqualified deferred compensation may be provided for under the terms of an individual's employment contract and apply only to that particular individual (although the same type of arrangement may be included in the employment contracts of multiple individuals).

A nonqualified arrangement may provide for the deferral of base compensation (i.e., salary), incentive compensation (e.g., commissions or bonuses), or supplemental compensation. The arrangement may permit the employee to elect, such as on an annual basis, whether to defer compensation or to receive it currently, similar to a salary reduction or cash-or-deferred arrangement under a qualified employer plan. Alternatively, the arrangement may provide for compensation that is payable only on the occurrence of future events, not currently.

A nonqualified deferred compensation arrangement may be structured as an account for the employee (similar to a defined contribution or individual account plan) or may provide for specified benefits to be paid to the employee (similar to a defined benefit pension plan). Under an account structure, depending on whether the arrangement is unfunded or funded, a hypothetical or actual account is maintained for the employee, to which specified contributions and earnings are credited. The employee may be permitted to direct the investments under the hypothetical or actual account. The benefits to which the employee is entitled are based on the amount in the account. Under a defined benefit structure, the terms of the nonqualified arrangement specify the amount of benefits (or formula for determining benefits) to be paid to the employee.

3. Specific types of plans

(a) In general

Certain types of nonqualified deferred compensation arrangements are referred to by specific terms, often based on a particular feature or purpose of the arrangement. Generally, these terms do not prescribe the structure of the arrangement other than with respect to the particular feature or purpose. In addition, because these terms often are not legally defined, they are not always used consistently.

(b) Top-hat plan

A "top-hat plan" is the term generally used for certain nonqualified deferred compensation plans that are exempt from most ERISA requirements. The ERISA exemption applies to a plan that is unfunded and is maintained by an employer primarily for the purpose of

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[3] Such arrangements are discussed in Part B.1, below.

providing deferred compensation for a select group of management or highly compensated employees. ERISA does not provide statutory definitions of "select group," "management," or "highly compensated employees," and the Department of Labor has not issued regulations defining these terms.[4] Employees sometimes claim ERISA protection (such as vesting or funding) for benefits under a nonqualified deferred compensation plan. However, most nonqualified deferred compensation arrangements are intended to fall under the top-hat exemption.

A top-hat plan is exempt from the ERISA requirements relating to participation and vesting, funding, and fiduciary responsibility. A top-hat plan is not exempt from the reporting and disclosure requirements or the administration and enforcement provisions under ERISA. However, under Department of Labor regulations, the reporting and disclosure requirements are satisfied by (1) a one-time filing with the Secretary of Labor of a statement that includes the name and address of the employer, the employer's tax identification number, a declaration that the employer maintains a plan or plans primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees, and a statement of the number of such plans and the number of employees in each, and (2) providing plan documents, if any, to the Secretary of Labor upon request.[5]

Another term commonly used for an unfunded plan that covers only a select group of management or highly compensated employees is a supplemental executive retirement plan or "SERP."

(c) Excess benefit plan

ERISA does not apply to an "excess benefit plan" that is unfunded. As a result, an unfunded excess benefit plan is exempt from all ERISA requirements. ERISA defines an excess benefit plan as a plan maintained by an employer solely for the purpose of providing benefits for certain employees in excess of the limits on contributions and benefits under section 415 of the Code, without regard to whether the plan is funded.[6] To the extent that a separable part of a plan (as determined by the Secretary of Labor) maintained by an employer is maintained to provide benefits in excess of the Code section 415 limits, that part is treated as a separate plan that is an excess benefit plan.

Coverage under an excess benefit plan need not be limited to a select group of management or highly compensated employees. Depending on the design of the plan that is subject to Code section 415, nonmangement or nonhighly compensated employees may be covered by an excess benefit plan. For example, a subsidized early retirement benefit provided to long-service employees (regardless of age) under a qualified defined benefit plan could exceed

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[4] The Code definition of "highly compensated employee" (sec. 414(q)) has not been applied for this purpose.

[5] 29 CFR 2520.104-23.

[6] The limits under sec. 415 apply to qualified defined contribution and defined benefit plans, which generally must be funded.

the section 415 limit applicable to a nonhighly compensated employee, making the employee eligible for benefits under an excess benefit plan. As a practical matter, however, the limits on contributions and benefits are more likely to affect highly paid employees. In addition, the terms of the excess benefit plan may limit coverage to certain management and highly compensation employees.

(d) "Make-up" or "mirror" plan

Nonqualified deferred compensation arrangements are sometimes designed to provide benefits in excess of Code limits that apply to qualified retirement plans other than the limits under section 415. For example, the Code limits the amount of annual compensation that may be taken into account under a qualified retirement plan ($200,000 for 2002) and the amount of an employee's annual elective deferrals ($11,000 for 2002). In addition, the amount of elective deferrals or matching contributions for a highly compensated employee may be limited in order to satisfy special nondiscrimination requirements that apply to such contributions. A plan that provides the additional benefits that cannot be provided under a qualified retirement plan because of these limits is sometimes referred to as a "make-up" plan (or "mirror" or "tandem" plan or SERP), based on its connection to the qualified plan.

A make-up plan does not meet the definition of an excess benefit plan under ERISA, which requires that the plan be maintained solely for the purpose of providing benefits in excess of the Code section 415 limits. However, a make-up plan may be a top-hat plan.

(e) Phantom stock plan

A "phantom stock" plan is a nonqualified deferred compensation arrangement under which deferred amounts are determined by reference to hypothetical (or "phantom") shares of employer stock. Phantom stock plans are often used to provide incentive compensation. For example, an employee may be awarded 1,000 units of phantom stock and have the right to "cash out" 200 shares a year over five years if certain performance goals are met. Depending on the terms of the arrangement, the employee may be entitled to receive only the growth in the value of the stock between the time the phantom shares are awarded and the time they are cashed out, or the employee may be entitled to receive the entire value of the stock at cash-out as well as any dividends paid since the time the phantom shares were granted. Actual shares of stock are not held for the employee under a phantom stock plan, but, depending on the terms of the plan, the employee may be entitled to be paid in actual shares or in cash at the time of the cash-out.

(f) Eligible deferred compensation plan of a tax-exempt employer

The Code limits the amount of nonqualified deferred compensation that can be provided by a tax-exempt employer on a tax-deferred basis (sec. 457). Generally, amounts deferred under a nonqualified deferred compensation arrangement of a tax-exempt employer (other than a church) are currently included in the employee's income unless the arrangement is an eligible deferred compensation plan (a "section 457 plan"). The maximum annual deferral under such a plan generally is $11,000 (for 2002), or the employee's total includible compensation, if less. In general, amounts deferred under a section 457 plan may not be made available to a plan participant before the earlier of (1) the calendar year in which the participant attains age 70-1/2,

(2) when the participant has a severance from employment with the employer, or (3) when the participant is faced with an unforeseeable emergency.

Amounts deferred under an eligible deferred compensation plan of a tax-exempt employer are includible in the employee's income when paid or otherwise made available to the employee. Amounts deferred under a section 457 plan of a tax-exempt entity must remain the property of the employer, subject only to the claims of the employer's general creditors.

If compensation is deferred under a plan that is not an eligible deferred compensation plan (an "ineligible plan"), deferred amounts are includible in income when the deferred compensation is not subject to a substantial risk of forfeiture, even if the deferred compensation is not funded.

4. Comparison with qualified employer plans

(a) Tax treatment and general qualification requirements

Qualified employer plans receive the following tax-favored treatment:

- Contributions to the plan (and earnings thereon) are not includible in the gross income of employees until the benefits are distributed, even though the plan is funded and the benefits are nonforfeitable;
- The employer is entitled to a current deduction (within limits) for contributions to the plan even though the contributions are not currently included in an employee's income; and
- The trust that holds the plan assets is tax-exempt.

Qualified employer plans are subject to various Code requirements that must be satisfied in order for favored tax treatment to apply. The particular requirements a qualified employer plan must satisfy in order to receive tax-favored treatment depends on the type of arrangement. In general, however, among the applicable rules are limits on the amount of contributions or benefits that can be provided, minimum participation rules that restrict the age and number of years of employment an employer can require as a condition of plan participation, nondiscrimination rules that seek to ensure that qualified retirement plans benefit a broad group of employees, and, in the case of certain plans, minimum funding rules designed to ensure that employer contributions are sufficient to provide for plan benefits. For example, the maximum annual contribution that can be made to a qualified defined contribution plan is the lesser of (1) 100 percent of compensation and (2) $40,000 (for 2002). The maximum annual benefit payable at age 62 under a qualified defined benefit plan is the lesser of (1) 100 percent of compensation and (2) $160,000 (for 2002).

Nonqualified deferred compensation does not receive such favorable tax treatment. For example, the employer is generally not entitled to a deduction for nonqualified deferred compensation until the compensation is includible in the gross income of the employee.[7] Such

[7] The tax treatment of nonqualified deferred compensation is discussed in detail in Part B, below.

compensation is also not subject to the limits applicable to qualified employer plans. Thus, for example, there is no dollar limit on the annual aggregate nonqualified deferred compensation that may be provided. Also, nonqualified deferred compensation arrangements typically are limited to a named class of employees; in some cases, a particular arrangement may cover a single employee.

(b) Eligible individuals

Qualified employer plans generally may cover only employees.[8] Nonqualified deferred compensation arrangements are not subject to this restriction, and thus may cover employees and individuals who are not employees. For example, a nonqualified deferred compensation arrangement may cover the "outside" directors of a corporation (i.e., directors who are not employees of the corporation) or independent contractors who provide services.[9]

(c) Funding and security

Qualified employer plans provide a high degree of security. Such plans are required to be funded, i.e., assets must be set aside exclusively to provide benefits to employers. Qualified employer plans assets may not be used by employers for purposes other than providing benefits and are not subject to the claims of creditors of the employer.

A nonqualified deferred compensation arrangement may be funded or unfunded, depending on the terms of the arrangement. As discussed below, whether such an arrangement is funded affects the tax treatment.

Qualified defined benefit pension plan benefits are guaranteed (within limits) by the Pension Benefit Guaranty Corporation ("PBGC"). The PBGC does not guarantee benefits under other types of qualified employer plans or under nonqualified deferred compensation arrangements.

(d) Application of ERISA

Most types of qualified employer plans are subject to requirements under Title I of the Employee Retirement Income Security Act of 1974 ("ERISA"), as well as under the Code. ERISA requirements deal with reporting and disclosure (part 1 of ERISA), participation and vesting (part 2), funding (part 3), fiduciary responsibility (part 4), and administration and enforcement (part 5).[10]

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[8] Self-employed individuals are generally considered employees for purposes of the rules relating to qualified employer plans.

[9] In general, arrangements discussed in this document may apply to individuals who are not employees as well as to employees.

[10] Some requirements under ERISA correspond to parallel requirements under the Code.

As discussed more fully in Part A.3, above, ERISA contains exemptions for nonqualified deferred compensation arrangements that are top-hat plans or excess benefit plans.[11] Most nonqualified deferred compensation arrangements are designed to fall within these ERISA exemptions. ERISA does not apply to nonqualified deferred compensation arrangements covering only nonemployees, such as outside directors.

[11] Governmental plans and church plans are also exempt from ERISA.

B. Tax Treatment of Nonqualified Deferred Compensation

1. Timing of income inclusion for the individual

(a) In general

The determination of when amounts deferred under a nonqualified deferred compensation arrangement are includible in the gross income of the individual earning the compensation depends on the facts and circumstances of the arrangement. A variety of tax principles and Code provisions may be relevant in making this determination, including the doctrine of constructive receipt, the economic benefit doctrine, the provisions of section 83 relating generally to transfers of property in connection with the performance of services, and provisions relating specifically to nonexempt employee trusts (sec. 402(b)) and nonqualified annuities (sec. 403(c)).

The following general rules regarding the taxation of nonqualified deferred compensation result from these provisions. In general, the time for inclusion of nonqualified deferred compensation depends on whether the arrangement is unfunded or funded. If the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received (i.e., when it is paid or otherwise made available). If the arrangement is funded, then it is generally treated as a transfer of property under section 83, and income is includible for the year in which the individual's right to the property is transferable or is not subject to a substantial risk of forfeiture.

(b) Income inclusion under an unfunded arrangement

As mentioned above, in the case of an unfunded nonqualified deferred compensation arrangement, amounts are includible in gross income when the amount is actually or constructively received.

An amount is constructively received if it is available to the individual so that he or she can draw on it at any time, even if the individual has not actually received the income.[12] Income is not constructively received if there is a substantial limitation or restriction on the individual's ability to withdraw it. A requirement that the individual provide advance notice in order to withdraw (or receive) the income is not considered a substantial limitation on the ability to withdraw it. However, a requirement that the individual relinquish a valuable right in order to withdraw the income is a substantial limitation.

For years before 1982, the constructive receipt doctrine applied to amounts payable under a qualified retirement plan.[13] Various IRS revenue rulings held that amounts held within a qualified retirement plan were not constructively received if, in order to receive a distribution, the participant was required to discontinue participation in the plan (either permanently or for a

[12] Treas. Reg. sec. 1.451-2(a).

[13] Before 1982, amounts were includible in income when distributed or made available. Since 1982, qualified retirement plan benefits are includible in income when distributed.

period of at least six months), forfeit a portion of his or her benefits, or lose past service credits or job retention rights in the case of reemployment.

A variety of methods in addition to these are used under nonqualified deferred compensation arrangements to provide some flexibility to individuals covered by the arrangement in obtaining distributions while attempting to avoid constructive receipt. For example, nonqualified deferred compensation arrangements frequently provide that distributions can be made in the event of financial hardship. Another technique sometimes used is to provide that the employer, plan administrative committee, or similar body can make distributions in its sole discretion. This is generally thought to avoid constructive receipt, although issues may arise if the discretion is illusory (i.e., requests are always granted). Another mechanism is to provide that withdrawals can be made at any time, but that a portion of the amount withdrawn, such as 10 percent, is forfeited to the employer if the distribution is made before some stated time or event. Other ways to avoid constructive receipt may also be used.

(c) Income inclusion under a funded arrangement

In general

As mentioned above, if a nonqualified deferred compensation arrangement is funded, then it is generally treated as a transfer of property under section 83, and income is includible for the year in which the individual's right to the property is transferable or is not subject to a substantial risk of forfeiture. The application of section 83 to a funded nonqualified deferred compensation arrangement is based in part on the broad scope of section 83 (i.e., section 83 applies to any transfer of property in connection with the performance of services) and the broad definition of property under section 83, as discussed below. Depending on the design of a particular nonqualified deferred compensation arrangement (e.g., if it covers only employees), either the economic benefit doctrine or Code provisions dealing with nonexempt employee trusts and nonqualified annuities may be relevant as legal authority for this tax treatment in addition to section 83.

Background

Economic benefit

Certain Code provisions apply in situations where assets are used to fund the deferred compensation obligation, such as a trust or an annuity contract. These provisions reflect concepts developed in connection with the traditional doctrine of economic benefit.

The economic benefit doctrine is based on the broad definition of gross income in the Code (sec. 61), which includes income in whatever form paid. Under the economic benefit doctrine, if an individual receives any economic or financial benefit or property as compensation for services, the value of the benefit or property is includible in the individual's gross income.

For example, courts have applied the economic benefit doctrine to the receipt of stock options or the receipt of an interest in a trust.[14]

A concept related to economic benefit is the cash equivalency doctrine. Under this doctrine, if the right to receive a payment in the future is reduced to writing and is transferable, such as in the case of a note or a bond, the right is considered to be the equivalent of cash and the value of the right is includible in gross income.[15]

In the case of nonqualified deferred compensation arrangements, these doctrines have been largely codified in the Code provisions discussed below. However, because many of the legal precedents related to nonqualified deferred compensation predate these Code provisions, the economic benefit and cash equivalency doctrines are sometimes considered in analyzing the tax treatment of nonqualified deferred compensation.

Rulings on nonqualified deferred compensation

In the 1960's and early 1970's, various IRS revenue rulings considered the tax treatment of nonqualified deferred compensation arrangements.[16] Under these rulings, a mere promise to pay, not represented by notes or secured in any way, was not regarded as the receipt of income for tax purposes. However, where an amount was contributed to an escrow account or trust on the individual's behalf, to be paid to the individual in future years with interest, the amount was held to be includible in income under the economic benefit doctrine. Deferred amounts were not currently includible in income in situations where nonqualified deferred compensation was payable from general corporate funds that were subject to the claims of general creditors and the plan was not funded by a trust, or any other form of asset segregation, to which individuals had any prior or privileged claim.[17] Similarly, current income inclusion did not result when the employer purchased an annuity contract to provide a source of funds for its deferred compensation liability if the employer was the applicant, owner and beneficiary of the annuity contract, and the annuity contract was subject to the general creditors of the employer.[18] In these situations, deferred compensation amounts were held to be includible in income when actually received or otherwise made available.

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[14] Commissioner v. Smith, 324 U.S. 177 (1945); E.T. Sproull v. Commissioner, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (1952).

[15] *See, e.g.,* Cowden v. Commissioner, 289 F.2d 20 (5th Cir. 1961).

[16] The seminal ruling dealing with nonqualified deferred compensation is Rev. Rul. 60-31, 1960-1 C.B. 174.

[17] Rev. Rul. 69-650, 1969-2 C.B. 106; Rev. Rul. 69-49, 1969-1 C.B. 138.

[18] Rev. Rul. 72-25, 1972-1 C.B. 127. *See also*, Rev. Rul. 68-99, 1968-1 C.B. 193, in which the employer's purchase of an insurance contract on the life of the employee did not result in an economic benefit to the employee where all rights to any benefits under the contract were solely the property of the employer and the proceeds of the contract were payable only to the employer.

Section 83

In general

Section 83 of the Code provides rules for the tax treatment of property transferred in connection with the performance of services. Under section 83, the excess of the fair market value of property received in connection with the performance of services over the amount, if any, paid for the property is includible in the income of the person performing the services ("service provider"). Income is generally includible for the year in which the service provider's right to the property is either transferable or is not subject to a substantial risk of forfeiture. The amount includible in income is based on the fair market value of the property at that time. However, under a special rule, if property is either nontransferable or is subject to a substantial risk of forfeiture when transferred, the service provider may elect within 30 days to apply section 83 as of the time of the transfer.[19]

Section 83 applies to a transfer of property to any service provider; its application is not limited to employees or even to individuals. A transfer of property occurs for purposes of section 83 when a person acquires a beneficial ownership interest in such property.

Definition of property

The term "property" is defined very broadly for purposes of section 83.[20] Property includes real and personal property other than money or an unfunded and unsecured promise to pay money in the future. Property also includes a beneficial interest in assets (including money) that are transferred or set aside from claims of the creditors of the transferor, for example, in a trust or escrow account. Accordingly, if, in connection with the performance of services, vested contributions are made to a trust on an individual's behalf and the trust assets may be used solely to provide future payments to the individual, the payment of the contributions to the trust constitutes a transfer of property to the individual that is taxable under section 83.

In the case of a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, only the cash surrender value is considered to be property. Where rights in a contract providing life insurance protection are substantially nonvested, the cost of the current life insurance protection thereunder (i.e., the reasonable net premium cost as determined by the Commissioner) is includible in income.

Substantial risk of forfeiture and transferability

Property is subject to a substantial risk of forfeiture if the individual's right to the property is conditioned on the future performance of substantial services (such as full-time

[19] Section 83 also governs the compensation deduction attributable to a transfer of property in connection with the performance of services, as discussed in Part B.2, below.

[20] Treas. Reg. sec. 1.83-3(e). This definition in part reflects previous IRS rulings on nonqualified deferred compensation.

services for two years or more) or on the nonperformance of services (such as a noncompete requirement). In addition, a substantial risk of forfeiture exists if the right to the property is subject to a condition other than the performance of services and there is a substantial possibility that the property will be forfeited if the condition does not occur. For example, if contributions are made to a trust exclusively for the purpose of reimbursing employees for education expenses, but reimbursement is available only if an employee takes a course and earns a passing grade, the employee's interest in the trust is subject to a substantial risk of forfeiture until he or she takes and passes a course. Under a special rule, property is considered to be subject to a substantial risk of forfeiture if sale of the property at a profit could subject the person to suit under section 16(b) of the Securities Exchange Act of 1934.

Risks that do not fall within this legal definition, such as the risk that the property will decline in value, do not result in a substantial risk of forfeiture. Whether a substantial risk of forfeiture exists depends on the facts and circumstances, including whether the service requirement or other condition will in fact be enforced. Property that is subject to a substantial risk of forfeiture is referred to as nonvested property; property that is not (or is no longer) subject to a substantial risk of forfeiture is referred to as vested property.

Property is considered transferable if a person can transfer his or her interest in the property to anyone other than the transferor from whom the property was received. However, property is not considered transferable if the transferee's rights in the property are subject to a substantial risk of forfeiture. A temporary restriction on the transferability of property (called a "lapse" restriction) is disregarded in determining the value of the property for purposes of section 83. A permanent restriction on the transferability of property (a "nonlapse" restriction) is taken into account in determining the value of the property.

Nonexempt trusts and nonqualified annuities

The Code contains provisions that deal specifically with nonexempt employee trusts and nonqualified employee annuities (i.e., trusts and annuities not meeting the requirements applicable to qualified retirement plans and annuities).[21] These provisions apply rules similar to those under section 83.[22] Under these provisions, if vested contributions are made to a nonexempt trust or a nonqualified annuity on an employee's behalf, the contributions are includible in the employee's income when made. If the employee's interest is not vested when contributions are made, the value of the employee's interest in the trust or annuity (including earnings since the time of contribution) is includible in the employee's income when it vests. The amount included in the employee's income constitutes cost or basis to the employee in the trust or annuity. Payments from the trust or annuity are taxed under the general rules that apply to annuities (sec. 72). That is, a portion of each payment is treated as a nontaxable return of basis and the remainder of each payment is includible in income. Section 83 applies to any service provider; however, these provisions apply only to trusts and annuities for employees.

[21] Secs. 402(b) and 403(c).

[22] Although these Code provisions predate the enactment of sec. 83 in 1969, they were amended at that time to reflect the enactment of sec. 83.

(d) Attempts to provide security for nonqualified deferred compensation

In general

As mentioned above, amounts deferred that are funded are includible in gross income in the year the amount is transferable or is no longer subject to a substantial risk of forfeiture. As in the case when the doctrine of constructive receipt applies, this rule can result in the imposition of tax even when no amount is actually received. For example, suppose a nonqualified deferred compensation plan provides that an employer will pay an employee (or the employee's beneficiary) $500,000 when the employee attains age 55 or dies. Further suppose that the plan is funded and provides that the employee's right to the $500,000 vests after five years of employment. Because the arrangement is funded, the employee must include the present value of $500,000 in income after he or she completes five years of employment, even if that is many years before the employee attains age 55. Given this type of result, individuals covered under nonqualified deferred compensation arrangements typically prefer for such arrangements not to be funded for tax purposes.

Nevertheless, such individuals are often interested in providing some security with respect to payment of the deferred compensation. Unfunded status presents the risk that the employee will not receive his or her deferred compensation payments when due.[23] Thus, the question that arises in many cases is what sort of security can be provided for the individual without incurring current income tax consequences, i.e., without having the arrangement being considered funded for tax purposes. Various arrangements have been developed in an effort to provide employees with security for nonqualified deferred compensation, some of which are discussed below.

Rabbi trusts

A "rabbi trust" is a trust or other fund established by the employer to hold assets from which nonqualified deferred compensation payments will be made. The trust or fund is generally irrevocable and does not permit the employer to use the assets for purposes other than to provide nonqualified deferred compensation. However, the terms of the trust or fund provide that the assets are subject to the claims of the employer's creditors in the case of bankruptcy.[24]

For purposes of section 83, property includes a beneficial interest in assets set aside from the claims of creditors, such as in a trust or fund, but does not include an unfunded and unsecured promise to pay money in the future. In the case of a rabbi trust, terms providing that the assets are subject to the claims of creditors of the employer in the case of bankruptcy have been the basis for the conclusion that the creation of a rabbi trust does not cause the related nonqualified deferred compensation arrangement to be funded for income tax purposes.[25] As a

[23] This risk is not a substantial risk of forfeiture as defined under sec. 83.

[24] A rabbi trust is generally a grantor trust of the employer for tax purposes, so trust earnings are treated as income to the employer.

[25] This conclusion was first provided in a 1983 private ruling issued by the IRS with respect to an arrangement covering a rabbi; hence the popular name "rabbi trust."

result, no amount is included in income by reason of the rabbi trust; generally income inclusion occurs as payments are made from the trust.[26]

Since the concept of a rabbi trust was developed, techniques have developed that attempt to protect the assets from creditors despite the terms of the trust. For example, the trust or fund may be located in a foreign jurisdiction, making it difficult or impossible for creditors to reach the assets.[27] In such a case, the existence of the assets may be unknown or the assets may be protected from creditors under the laws of the jurisdiction where the trust is located.

Secular trusts

In contrast to a rabbi trust, a "secular" trust is a trust established by an employer exclusively for the purpose of providing nonqualified deferred compensation; assets are not subject to claims of creditors. A secular trust constitutes a funding of a nonqualified deferred compensation arrangement, so that vested amounts are includible in income by the employees (i.e., such amounts are not tax-deferred).[28] A secular trust provides security for the employees, but also causes current taxation. In some cases, under the terms of the nonqualified deferred compensation arrangement, the employer pays the taxes attributable to the deferred compensation by grossing up the employees' current compensation by a corresponding amount.

Other forms of security

Other methods are sometimes used in an attempt to provide employees with security that deferred compensation payments will be made when due, such as third party guarantees, letters of credit, and surety bonds. There is little specific guidance as to how these arrangements should be treated for tax purposes. In addition, the tax treatment depends on the facts of the particular arrangement.

2. Timing of deduction

Special statutory provisions govern the timing of the deduction for nonqualified deferred compensation, regardless of whether the arrangement covers employees or nonemployees and regardless of whether the arrangement is funded or unfunded.[29] Under these provisions, the amount of nonqualified deferred compensation that is includible in the income of the individual performing services is deductible by the service recipient for the taxable year in which the amount is includible in the individual's income.

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[26] The same analysis has been applied to conclude that the rules of sec. 402(b), relating to nonexempt employee trusts, do not apply to a rabbi trust.

[27] An offshore rabbi trust has been referred to as a "Rastafarian" rabbi trust, based on its location.

[28] A secular trust is generally structured as a separate entity for tax purposes, and earnings are includible in the income of the trust.

[29] Secs. 404(a)(5), (b) and (d) and sec. 83(h).

3. Payroll taxes and wage reporting

(a) In general

In the case of an employee, nonqualified deferred compensation is generally considered wages both for purposes of income tax withholding and for purposes of taxes under the Federal Insurance Contributions Act ("FICA"), consisting of social security tax and Medicare tax. However, the income tax withholding rules and social security and Medicare tax rules that apply to nonqualified deferred compensation are not the same.

(b) Income tax withholding

Nonqualified deferred compensation is generally subject to income tax withholding at the time it is includible in the employee's income as discussed above. In addition, such amounts must be reported as income tax wages on a Form W-2. Income tax withholding and Form W-2 reporting are required even if the employee has already terminated employment. For example, if nonqualified deferred compensation is includible in income only as payments are made after retirement, income taxes must be withheld from the payments and the payments must be reported on a Form W-2.

Income tax withholding and Form W-2 reporting are required when amounts are includible in income even if no actual payments are made to the employee. For example, if nonqualified deferred compensation is provided by means of vested contributions to a funded arrangement, the amount of the contributions is includible in the employee's income and is subject to income tax withholding[30] and Form W-2 reporting. Additional income tax withholding and reporting may be required when payments are made from the funded arrangement to the extent a portion of the payments are includible in income (i.e., amounts in excess of the employee's basis). Such amounts are subject to the income tax withholding rules that apply to pensions and are reported on a Form 1099R.

Generally, the employer is responsible for income tax withholding and Form W-2 reporting (or Form 1099R, if applicable) with respect to nonqualified deferred compensation. However, if nonqualified deferred compensation payments are made by a third party, such as the trustee of a trust, and are not under the control of the employer, the payor is responsible for income tax withholding and reporting.

(c) Social security and Medicare taxes

The Code provides special rules for applying social security and Medicare taxes to nonqualified deferred compensation.[31] In general, nonqualified deferred compensation is subject

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[30] The required income tax withholding is accomplished by withholding income taxes from other wages paid to the employee in the same year.

[31] Because nonqualified deferred compensation arrangements generally cover only highly paid employees, the other compensation paid to the employee during the year generally exceeds the social security wage base. In that case, nonqualified deferred compensation amounts are subject only to Medicare tax.

to social security and Medicare tax when it is earned (i.e., when services are performed), unless the nonqualified deferred compensation is subject to a substantial risk of forfeiture. If nonqualified deferred compensation is subject to a substantial risk of forfeiture, it is subject to social security and Medicare tax when the risk of forfeiture is removed (i.e., when the right to the nonqualified deferred compensation vests). This treatment is not affected by whether the arrangement is funded or unfunded, which is relevant in determining when amounts are includible in income (and subject to income tax withholding).

The amount of nonqualified deferred compensation that is treated as wages for social security and Medicare tax purposes depends on whether it is an account-type arrangement. In the case of an account-type arrangement, the amount treated as wages is generally the vested amount credited to the employee's account or the value of the account at vesting. In the case of other arrangements, such as a defined benefit-type arrangement, the amount treated as wages is the present value of the amount (or amounts) to be paid to the employee in the future. The present value of the future payments is determined actuarially.[32]

[32] Under a special rule, if the amount, form, or commencement date of the future payments is not known, so that the amount of the payments is not reasonably ascertainable, social security and Medicare taxes may be applied at the time the amount becomes reasonably ascertainable.

C. General Issues Relating to Nonqualified Deferred Compensation

Reasons for nonqualified deferred compensation arrangements

Nonqualified deferred compensation is a common form of executive compensation. Deferring compensation may be attractive for a variety of reasons. Individual service providers may want to defer compensation to a future date because they believe that their tax burden will be lower in the future than it is currently, thus resulting in payment of lower taxes than if the compensation had been received currently. This may occur, for example, if an individual believes that income tax rates will be lower in the future or if the individual anticipates having lower income in the future than currently. Some individuals may wish to retire early, and thus defer payment of current income until after their expected retirement date. Others may want to defer compensation to provide for future expected expenses, such as college expenses for their children.

Employers often use deferred compensation agreements to induce or reward certain behavior. For example, an employer may provide that certain compensation will be paid only if an executive continues employment for a certain number of years in order to provide an incentive for the executive to remain with the employer for a minimum period of time.

Qualified retirement plans and similar arrangements are one means of providing deferred compensation. In the case of executives and similar personnel, however, in many cases the amount of compensation provided through nonqualified arrangements far exceeds the amount of benefits provided through the qualified plan. There may be several reasons for this. Some argue that the reduction in the amount of benefits that could be provided through a qualified plan that took place during the 1980's caused some employers to abandon qualified plans (or to not adopt a qualified plan) because there was not enough incentive for the owner to establish a plan. Concerns of this sort were one of the reasons the limits on qualified plan benefits were increased in the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"). For example, EGTRRA increased the maximum amount of compensation that may be taken into account under a qualified plan from $170,000 to $200,000 (for 2002), thus enabling higher income individuals to receive greater benefits under a qualified plan. The amount of benefits that may be provided under a qualified plan for the owners is more likely to influence the decision of whether to establish a plan in the case of smaller or medium-sized employers.

In some cases, the amount of deferred compensation that may be provided under a qualified retirement plan may have little bearing on the amount of nonqualified deferred compensation provided. Other factors may have more weight, including the desire for flexibility with respect to such matters as which employees are eligible under the deferred compensation arrangement, vesting, funding, and other plan terms. The fact that there is no limit on the amount that may be deferred is also a factor. In theory, there is a tension between the amount of deferred compensation an employer is willing to provide and the amount executives may seek, because the employer is not entitled to a deduction until there is an income inclusion. However, in practice, in many cases this supposed tension does not appear to have much effect; in some cases millions of dollars may be deferred annually by a single individual.

Security and access with respect to nonqualified deferred compensation

As discussed above, in order for an individual to avoid current income inclusion with respect to amounts deferred under a nonqualified arrangement: (1) in the case of an unfunded arrangement, there must be substantial limitations on the right to withdraw funds, or (2) in the case of a funded arrangement, the deferred compensation must be subject to a substantial risk of forfeiture. As a result of these limitations, individuals covered under nonqualified deferred compensation arrangements face two main risks: (1) they will not have access to deferred amounts when they want them; and (2) the employer will be unable or unwilling to make the payments. Access issues may arise, for example, if the individual has unanticipated financial needs before the payments are scheduled to begin. Issues regarding the employer's ability or willingness to make payments may arise, for example, if the employer enters bankruptcy, if the employee falls out of favor with management, or in the case of a change in control of the employer.[33]

Attempts to provide executives with increased access and security with respect to nonqualified deferred compensation have led to the development of a variety of techniques (some of which are mentioned above). Some of these may be based on aggressive positions with respect to the question of whether current income taxation results. For example, ways to increase access include allowing distributions in the event of financial hardship. There is no clear definition of financial hardship, which may allow considerable flexibility in designing arrangements. For example, some may argue that it is appropriate to use the definition employed under the qualified retirement plan rules, which include home-buying expenses and college education expenses. Some plans employ a so-called "haircut" approach, which allows the individual access to funds at any time, with the proviso that a portion of the distribution is forfeited to the employer. Some plans may use a 10-percent haircut. Again, this uses the qualified retirement plan rules as a guide--there is a 10-percent early withdrawal tax on amounts withdrawn before age 59-1/2, unless an exception applies. Questions may arise as to what is the lowest amount of the "haircut" that does not result in current taxation. Loans based on nonqualified deferred compensation arrangements may also be used to increase access to deferred amounts.

Other efforts to provide security without causing current taxation include letters of credit, insurance arrangements that insure against future nonpayment by the company, and alternatives to "rabbi trusts," such as locating the trust offshore where, as a practical matter, it is outside the reach of creditors. Another approach to providing security is to have a trigger mechanism that results in distributions before the event giving rise to the risk of nonpayment occurs. For example, payment could be triggered upon the occurrence of certain financial events that indicate a possible financial downturn for the employer.

The means that can be developed to try to increase access and security under nonqualified deferred compensation arrangements, without causing current income inclusion, are probably

[33] In these circumstances, the employee has a contractual right to receive the nonqualified deferred compensation, but the contractual right may be difficult to enforce.

endless. While some arrangements probably do not provide the desired tax consequences, in other cases the proper tax treatment may be unclear.

Tax policy issues with respect to nonqualified deferred compensation arrangements

Among other factors, tax policy is concerned with the proper timing of income inclusion and deductions. With respect to the timing of the deduction for nonqualified deferred compensation, present law is generally viewed as providing the appropriate result by matching the employer deduction with the income inclusion. However, nonqualified deferred compensation arrangements, particularly those that seek to provide increased security and access, may raise issues as to the proper timing of the income inclusion. Determining the proper tax treatment of such arrangements may present problems for several reasons. For example, it may be unclear how the law applies in particular cases because of the variety of the arrangements and the fact-specific nature of the relevant legal principles. In addition, it may be difficult for the IRS to enforce the rules in some cases, because it may be difficult to ascertain the existence of a nonqualified deferred compensation arrangement, as well as other facts that may be relevant in determining the proper tax treatment (such as the existence of trusts or other security arrangements).

Some argue that clarification of the law in this area would be appropriate to provide additional guidance for both taxpayers and the IRS. Because of the diversity of possible arrangements, it may be impossible to address all situations, it may be possible to address only some circumstances. Some also argue that it may be appropriate to review whether present law results in the proper timing of the income inclusion. For example, some arrangements raise issues as to whether restrictions on access or other provisions are illusory, and thus raise the question of when the income inclusion should occur. For example, suppose nonqualified deferred compensation is provided through a rabbi trust; thus, the funds are subject to the claims of general creditors of the employer. Suppose further that other provisions of the arrangement, such as triggers for payment, make it unlikely that any of the assets will in fact be available for creditors in the event the employer becomes bankrupt because the funds will be paid to the individual in advance of the bankruptcy. If this arrangement is considered unfunded for tax purposes, then there will be no income inclusion until amounts are actually or constructively received. Some would argue that the arrangement is in fact not subject to the claims of creditors, so that the arrangement should be considered funded, and income inclusion should occur when there is no substantial risk of forfeiture.

Other issues

Other issues are sometimes raised with respect to nonqualified deferred compensation arrangements. For example, some are concerned with the amount of compensation that is deferred and believe limits should be placed on such compensation, whether through the tax Code or otherwise. Some also raise questions of fairness with respect to nonqualified deferred compensation compared to the compensation and benefits provided to rank and file employees. On the other hand, some argue that it is appropriate to allow businesses to compensate executives as they deem necessary in order to be competitive and attract key personnel.

II. SPLIT-DOLLAR LIFE INSURANCE ARRANGEMENTS

A. Description of Split-Dollar Arrangements

In general

The term "split-dollar life insurance" refers to the splitting the cost and benefits of a life insurance contract. The cost of premiums for the contract often is split between two parties. One party typically pays the bulk of the premiums, and is repaid in the future from amounts received under the contract. The other party often pays a small portion of the premiums, but has the right to designate the recipient of the bulk of the future benefits under the contract.

Split-dollar life insurance arrangements have been used for several purposes. A principal use has been by employers, to provide low-cost term life insurance benefits or to fund other compensatory benefits (such as salary continuation) for employees on a tax-favored basis. Split-dollar life insurance arrangements are also used in other contexts. For example, such an arrangement can be used to fund a buy-sell agreement between shareholders or owners of a business, or to provide estate liquidity (sometimes with a trust as the owner of the contract).

The type of life insurance generally used in a split-dollar life insurance arrangement is referred to as whole life insurance. This does not refer to the period for which the insurance contract is in effect, but rather, to the fact that the contract has a "cash value," as well as providing a death benefit upon the death of the insured person. The cash value arises because the premiums paid to the insurer for the contract are invested, and some of this investment income is credited to the contract. Thus, the amount of the future death benefit payable under the contract is funded both by premium payments, and by investment earnings on the premium payments. The amount of the cash value at any point in time generally is the sum of the premiums paid plus the earnings on premiums that are credited to the policy, reduced by the cost of death benefit coverage for the current period, fees, and other charges imposed by the insurer. The amount of the cash value generally is zero or small at first, and increases over the duration of the contract. The cash value of a whole life insurance contract usually may be borrowed or withdrawn by the contract holder (reducing the amount that will be paid as a death benefit under the contract). A whole life insurance contract can be contrasted with a term life insurance contract, which pays a death benefit upon the death of the insured person, but has no cash value. Under a term life insurance contract, the death benefit coverage applies only for a set term (e.g., one year or five years), and the premium payments are set at a level to fund the death benefit only during that period. The contract holder does not have the right to borrow or withdraw cash under a term life insurance contract, because it has no "cash value."

Methods for splitting the cash value and death benefits of a life insurance contract

The benefits that are split under a split-dollar life insurance arrangement generally are the death benefit (the amount paid upon the death of the insured person), and the cash value (which includes the earnings under the contract). Because the arrangement is by contract, the parties can split these features of the life insurance contract in whatever manner they agree upon. Over the past 50 years, a variety of split-dollar life insurance products have been developed.

One form of split-dollar life insurance arrangement is known as the endorsement method. Under this arrangement, as applied, for example, between an employer and an employee, the employer is the owner of the contract and pays the bulk of the premiums. The employee generally is the insured person, and pays a smaller amount of the premiums. The employer endorses over to the employee the right to designate the beneficiary of the death benefit under the contract. The employer's premium payments are repaid from the cash value of the contract or from the death benefit when the insured employee dies. Under some arrangements, ownership of the contract is turned over, or "rolled out," to the employee at a contractually agreed time, such as upon retirement, after the employer has recouped its premium payments.

Another common type of split is referred to as the collateral assignment method. Under this arrangement, as applied, for example, between an employer and an employee, the employee (or sometimes a trust he or she establishes) owns the policy and pays the premiums with amounts loaned by the employer, assigning the life insurance contract as collateral for the loans. The employer has the right to the portion of the cash value of the contract funded by its premium loans, but the employee (or trust) has the right to designate the beneficiary of the death benefits. The employee (or trust) may also have the right to the portion of the cash value of the contract that exceeds the employer's share of the cash value, if any.

Other types of splits are also possible, in which ownership of the cash value, the right to death benefits, or both, are split between the parties (e.g., between the employer and employee (or trust)). Arrangements in which the cash value is split between the parties are sometimes referred to as equity split-dollar arrangements. Another variation, sometimes referred to as a reverse split-dollar arrangement, is created when the owner of the contract and its cash value is the employee; the employee pays premiums with amounts loaned or reimbursed by the employer. The employee endorses or assigns to the employer the right to the death benefit under the contract, and perhaps also a portion of the cash value.

B. Tax Treatment of Split-Dollar Life Insurance Arrangements Between Employer and Employee

Transfers of property to employees

Under present law, as described in more detail above, compensation of an employee generally is included in the employee's income when it is received (or constructively received), if as is generally the case, the individual employee is a cash method taxpayer. If property is transferred to a person in connection with the performance of services, the fair market value of the property (reduced by the amount, if any, that is paid for the property) generally is included in income at the time the interest in the property is transferable, or is not subject to a substantial risk of forfeiture (whichever is sooner).[34]

Split-dollar life insurance

Present law provides that no Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract ("inside buildup"). Amounts paid by reason of the death of the insured under the contract ("death benefits") are also generally excluded from income of the recipient.[35]

Other favorable rules apply to amounts paid out or borrowed under a life insurance contract. Distributions from the contract prior to the death of the insured generally are taxed only to the extent they exceed the taxpayer's investment in the contract; that is, the distributions are first treated as tax-free recovery of the investment in the contract, and then the excess is included in income.[36]

Present law provides that no deduction is allowed for premiums on any life insurance contract if the taxpayer is directly or indirectly a beneficiary under the contract.[37]

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[34] Sec. 83.

[35] Sec. 101(a). An exception is provided to this general rule of exclusion for death benefits, in the case of a transfer of a life insurance contract for valuable consideration. The amount of the death benefit includable in the beneficiary's income under this exception is the amount that exceeds the premiums and other consideration paid for the contract by the transferee. However, this rule of inclusion does not apply in certain cases, including when the transfer is to the insured or to a corporation in which the insured is a shareholder or officer. Sec. 101(b).

[36] These favorable distribution rules do not apply to certain types of high-initial-premium policies (those funded more rapidly than seven annual level premiums); for those contracts, known as modified endowment contracts, distributions (and loans) are treated as income first, then tax-free recovery of investment in the contract.

[37] Sec. 264(a)(1).

Until 2001, IRS guidance as to the Federal income tax treatment of split-dollar arrangements was limited. In the 1960's, the IRS published rulings providing that the amount includable in an employee's income under a split-dollar insurance arrangement is the cost of current term insurance protection (less the amount, if any, paid by the employee). Any policyholder dividends paid to, or benefiting, the employee are also includable in income. In determining the cost of current term insurance protection, the employee may use either the cost as determined under an actuarial table known as the "P.S. 58 table," or the insurer's published rates for 1-year term life insurance coverage. This electivity arguably permitted the parties to the arrangement to choose the lower rate for determining the amounts includable in the employee's income, or the higher rate for determining the employer's share (as in a reverse split-dollar arrangement).[38]

Recent IRS guidance

Notice 2001-10

In January 2001, the IRS issued Notice 2001-10.[39] It provided interim guidance for the tax treatment of split-dollar life insurance, including types of split-dollar life insurance arrangements between employer and employee in which the employee has an interest in the cash value of the contract (equity split-dollar arrangements) that were not addressed by the 1960's rulings.

Notice 2001-10 provided that the IRS generally would accept the parties' characterization of a split-dollar life insurance arrangement in either of two ways. The first way is to treat the employee as owner of the contract, and treat the employer's payments for premiums as loans to the employee. Foregone interest on the loans is included in the employee's income under the low-interest loan rules of present law.[40] If the loans are not repaid, they become includible in income under these rules. Distributions to the employee under the insurance contract would also be includible in the employee's income under this characterization.

Under the second way of characterizing the arrangement, the employer is treated as owning the contract through its share of the premium payments. The employee is treated as having compensation income equal to the value of the life insurance protection provided each year that the arrangement remains in effect (reduced by any payments the employee makes toward such protection). Similarly, the employee includes in income any dividends or similar distributions to him under the contract. This generally continues the treatment provided under the 1960's rulings for the cost of current insurance protection.

Notice 2001-10 also specifically provided that the present-law rules taxing transfers of property to employees apply to split-dollar life insurance arrangements in which the employer transfers the cash value of the life insurance contract to the employee. Thus, under the Notice, if

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[38] Rev. Rul. 64-328, 1964-2 C.B. 11, and Rev. Rul. 66-110, 1966-1 C.B. 12.

[39] 2001-05 I.R.B. 459.

[40] Sec. 7872.

the employer is treated as owning the contract, the employee is treated as having compensation income to the extent that the employee acquires a substantially vested interest in the cash value of the contract.[41] For example, if the contract is "rolled out" to the employee at some point, such as upon retirement, under the terms of the split-dollar arrangement, then the employee would generally include the cash value in income at that time.

Notice 2001-10 provided a new table, Table 2001, to replace the P.S. 58 table for valuing the cost of current life insurance protection. The Notice also provided that, after 2003, taxpayers would no longer be permitted to choose to determine the value of current life insurance protection by using the insurer's lower published premium rates (as under the 1960's rulings). Rather, Table 2001 would be used to determine the value.

Notice 2002-8

A year after Notice 2001-10 was issued, it was revoked by Notice 2002-8.[42] Notice 2002-8, however, retained some of the general concepts of the earlier Notice, and also provided that Table 2001 generally would apply for valuation purposes for arrangements entered into after January 28, 2002 (the date Notice 2002-8 was issued). It also provided that for valuation purposes under such arrangements, the taxpayer may continue to choose the insurer's lower published premium rates; however, after 2003, these rates must be rates at which the insurer regularly sells term insurance (not just published rates).

Notice 2002-8 states that proposed regulations will be issued requiring taxation of the parties to a split-dollar life insurance arrangement under one of two regimes like those described in the earlier Notice (the loan and non-loan situations). Unlike the earlier Notice, the taxpayers' characterizations would not be determinative, but rather, the determination of which regime applies is based on whether the employer or the employee is formally designated as the owner of the contract.

If the employee is the owner, then the premiums paid by the employer would be treated as loans if the employee is obligated to repay the employer, whether out of contract proceeds or otherwise. Foregone interest would be treated as compensation income under the below-market interest rules of present law.[43] If the employee is not obligated to repay the employer, the premium amounts paid by the employer would be treated as income to the employee.

If the employer is the owner of the contract, then the employer would be treated as providing current life insurance protection and other economic benefits to the employee, as under the 1960's rulings. The value of these benefits is included in the employee's income (using Table 2001 in lieu of the P.S. 58 table, as described above). A transfer ("roll out") of the life

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[41] Sec. 83.

[42] 2002-4 I.R.B. 398.

[43] Sec. 7872.

insurance contract would cause its cash value to be includable in the employee's income, as under the interim guidance provided in the earlier Notice.[44]

Unlike the earlier Notice, Notice 2002-8 provides that the proposed regulations will not treat an employer as having made a transfer of the cash value of a contract to the employee that is includible in the employee's income, solely because the earnings credited to the contract cause the total amount of the cash value to exceed the employer's share of it. Notice 2002-8 does not specifically address the situation in which the employer and the employee both have ownership rights with respect to the cash value of a life insurance contract.

Notice 2002-8 specifically provides that the proposed regulations addressing the Federal tax treatment of split-dollar life insurance arrangements will be effective for arrangements entered into after the date of publication of final regulations.

[44] Sec. 83.

III. MISCELLANEOUS PROVISIONS RELATING TO EXECUTIVE COMPENSATION

A. Limitation on Deduction for Compensation in Excess of $1 Million

In general

A corporation generally may deduct compensation expenses as an ordinary and necessary business expense. However, the otherwise allowable deduction for compensation paid or accrued with respect to a covered employee of a publicly held corporation[45] is limited to no more than $1 million per year (sec. 162(m)).[46] The deduction limitation applies when the deduction would otherwise be taken. Thus, for example, in the case of compensation resulting from a transfer of property in connection with the performance of services, such compensation is taken into account in applying the deduction limitation for the year for which the compensation is deductible under section 83.

Covered employees

Covered employees are defined by reference to the Securities and Exchange Commission ("SEC") rules governing disclosure of executive compensation. Thus, with respect to a taxable year, a person is a covered employee if (1) the employee is the chief executive officer of the corporation (or an individual acting in such capacity) as of the close of the taxable year or (2) the employee's total compensation is required to be reported for the taxable year under the Securities Exchange Act of 1934 because the employee is one of the four highest compensated officers for the taxable year (other than the chief executive officer). If disclosure is required with respect to fewer than four executives (other than the chief executive officer) under the SEC rules, then only those for whom disclosure is required are covered employees.

Compensation subject to the deduction limitation

In general

Unless specifically excluded, the deduction limitation applies to all remuneration for services, including cash and the cash value of all remuneration (including benefits) paid in a medium other than cash. If an individual is a covered employee for a taxable year, the deduction limitation applies to all compensation not explicitly excluded from the deduction limitation, regardless of whether the compensation is for services as a covered employee and regardless of when the compensation was earned. The $1 million cap is reduced by excess parachute payments (as defined in sec. 280G, discussed below) that are not deductible by the corporation.

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[45] A corporation is treated as publicly held if it has a class of common equity securities that is required to be registered under section 12 of the Securities Exchange Act of 1934.

[46] This deduction limitation applies for purposes of the regular income tax and the alternative minimum tax.

Certain types of compensation are not subject to the deduction limit and are not taken into account in determining whether other compensation exceeds $1 million. The following types of compensation are not taken into account: (1) remuneration payable on a commission basis; (2) remuneration payable solely on account of the attainment of one or more performance goals if certain outside director and shareholder approval requirements are met ("performance-based compensation"); (3) payments to a tax-qualified retirement plan (including salary reduction contributions); (4) amounts that are excludable from the executive's gross income (such as employer-provided health benefits and miscellaneous fringe benefits (sec. 132)); and (5) any remuneration payable under a written binding contract which was in effect on February 17, 1993, and all times thereafter before such remuneration was paid and which was not modified thereafter in any material respect before such remuneration was paid.

Performance-based compensation

In general.--Compensation qualifies for the exception for performance-based compensation only if (1) it is paid solely on account of the attainment of one or more performance goals, (2) the performance goals are established by a compensation committee consisting solely of two or more outside directors[47], (3) the material terms under which the compensation is to be paid, including the performance goals, are disclosed to and approved by the shareholders in a separate vote prior to payment, and (4) prior to payment, the compensation committee certifies that the performance goals and any other material terms were in fact satisfied.

Definition of performance-based compensation.--Compensation (other than stock options or other stock appreciation rights) is not treated as paid solely on account of the attainment of one or more performance goals unless the compensation is paid to the particular executive pursuant to a preestablished objective performance formula or standard that precludes discretion. In general, this means that a third party with knowledge of the relevant performance results could calculate the amount to be paid to the executive. What constitutes a performance goal includes, for example, any objective performance standard that is applied to the individual executive, a business unit (e.g., a division or a line of business), or the corporation as a whole. Performance standards could include, for example, increases in stock price, market share, sales, or earnings per share.

Stock options or other stock appreciation rights generally are treated as meeting the exception for performance-based compensation, provided that the requirements for outside director and shareholder approval are met (without the need for certification that the performance standards have been met), because the amount of compensation attributable to the options or

[47] A director is considered an outside director if he or she is not a current employee of the corporation (or related entities), is not a former employee of the corporation (or related entities) who is receiving compensation for prior services (other than benefits under a tax-qualified pension plan), was not an officer of the corporation (or related entities) at any time, and is not currently receiving compensation for personal services in any capacity (e.g., for services as a consultant) other than as a director.

other rights received by the executive would be based solely on an increase in the corporation's stock price.

Stock-based compensation is not treated as performance-based if it is dependent on factors other than corporate performance. For example, if a stock option is granted to an executive with an exercise price that is less than the current fair market value of the stock at the time of grant, then the executive would have the right to receive compensation on the exercise of the option even if the stock price decreases or stays the same. Thus, stock options that are granted with an exercise price that is less than the fair market value of the stock at the time of grant do not meet the requirements for performance-based compensation. Similarly, if the executive is otherwise protected from decreases in the value of the stock (such as through automatic repricing), the compensation is not performance-based.

In contrast to options or other stock appreciation rights, grants of restricted stock are not inherently performance-based because the executive may receive compensation even if the stock price decreases or stays the same. Thus, a grant of restricted stock is treated like cash compensation and does not satisfy the definition of performance-based compensation unless the grant or vesting of the restricted stock is based upon the attainment of a performance goal and otherwise satisfies the standards for performance-based compensation.

Compensation does not qualify for the performance-based exception if the executive has a right to receive the compensation notwithstanding the failure of (1) the compensation committee to certify attainment of the performance goal (or goals) or (2) the shareholders to approve the compensation.

Shareholder approval and adequate disclosure.--In order to meet the shareholder approval requirement, the material terms under which the compensation is to be paid must be disclosed and, after disclosure of such terms, the compensation must be approved by a majority of shares voting in a separate vote.

In the case of performance-based compensation paid pursuant to a plan (other than a stock option plan), the shareholder approval requirement generally is satisfied if the shareholders approve the specific terms of the plan, including the class of executives to which it applies. In the case of a stock option plan, the shareholders generally must approve the specific terms of the plan, the class of executives to which it applies, the option price (or formula under which the price is determined), and the maximum number of shares subject to option that can be awarded under the plan to any executive. Further shareholder approval of payments under a plan or grants of options is not required after the plan has been approved. If there are material changes to the plan, shareholder approval would have to be obtained again in order for the exception to apply to payments under the modified plan.

B. Taxation of Excess Parachute Payments

In general

In some cases, the compensation agreement for a corporate executive may provide for payments to be made if the executive loses his or her job as a result of a change in control of the company. Such payments are referred to as "golden parachute payments." The Code contains limits on the amount of such payments. Payments in excess of those limits (i.e., "excess parachute payments) are not deductible by the corporation (sec. 280G). In addition, a nondeductible 20-percent excise tax is imposed on the recipient of any excess parachute payment (sec. 4999).

Definition of parachute payment

A "parachute payment" is any payment in the nature of compensation to (or for the benefit of) a disqualified individual which is contingent on a change in the ownership or effective control of a corporation (or on a change in the ownership of a substantial portion of the assets of a corporation), if the aggregate present value of all such payments made or to be made to the disqualified individual equals or exceeds three times the individual's "base amount."

The individual's base amount is the average annual compensation with respect to the acquired corporation includible in the disqualified individual's gross income over the five-taxable years of such individual preceding the individual's taxable year in which the change in ownership or control occurs.

The term parachute payment also includes any payment in the nature of compensation to a disqualified individual if the payment is made pursuant to an agreement which violates any generally enforced securities laws or regulations.

Certain amounts are not considered parachute payments, including payments under a qualified retirement plan, and payments that are reasonable compensation for services rendered on or after the date of the change in control. In addition, the term parachute payment does not include any payment to a disqualified individual with respect to a small business corporation or a corporation no stock of which was readily tradable if certain shareholder approval requirements are satisfied.

Disqualified individual

A disqualified individual is any individual who is any employee, independent contractor, or other person specified in regulations who performs personal services for the corporation and who is an officer, shareholder, or highly compensated individual of the corporation. Personal service corporations and similar entities are generally treated as individuals for this purpose. A highly compensated individual is defined for this purpose as an employee (or a former employee) who is among the highest-paid one percent of individuals performing services for the corporation (or an affiliated corporation) or the 250 highest paid individuals who perform services for a corporation (or affiliated group).

Excess parachute payments

In general, excess parachute payments are any parachute payments in excess of the base amount allocated to the payment. The amount treated as an excess parachute payment is reduced by the portion of the payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered before the change in control.

C. Limitations on Corporate-Owned Life Insurance ("COLI")

1. Background and description

Structure of COLI arrangements historically

The term COLI refers to life insurance contracts owned by a business (whether or not the business is actually in corporate form). The structure of a COLI arrangement generally has been that a business buys life insurance of a type that has a cash value, and after the cash value has built up sufficiently, the business borrows some portion of the cash value. The business can borrow directly from the policy, under a loan administered by the insurance company that issued the policy. In such a case, the amounts borrowed with respect to the contracts may be repaid by means of a reduction in the death benefits when the person insured under the contract dies. Alternatively, the business may borrow from a third party lender, perhaps using the life insurance contract as security for the loan, either formally or informally. The life insurance contract or contracts in COLI arrangements typically have covered the life or lives of employees, customers, or other individuals in whom the business has an insurable interest under applicable State law. The type of life insurance contract used for COLI is a type of contract that has cash value, and is often referred to generically as whole life insurance. This type of life insurance can be distinguished from term life insurance, which normally has no cash value.

Use as funding vehicle

COLI policies have been used as an indirect funding vehicle for employee benefits (or for any other cash need of the business). Because the policies are not specifically allocated to fund a particular expenditure, they can be used as a means of providing liquidity when direct funding of a future obligation is not necessary or is undesirable. For example, borrowings under COLI policies have been used to pay employers' obligations under retiree health plans, or to make payments under unfunded deferred compensation arrangements.

Borrowing in connection with COLI

Patterns of business borrowings with respect to life insurance contracts the business owns have changed over the past several decades. These changes have resulted from growth in the marketing to businesses of life insurance on employees, customers or other individuals, and also from changes in the tax law, among other factors.

Borrowing with respect to a life insurance contract is attractive because the earnings under the policy ("inside buildup") increase tax-free. These loans permit the borrower to have the current use of income that has not been taxed. Interest paid by the borrower is credited to the policy, which he owns, so the effect is equivalent to paying interest to himself. The amount of the loan reduces the death benefit when the insured person dies, if the loan has not yet been repaid; however, this is not a disadvantage to the borrower if another person (such as an employee's spouse) is the recipient of the death benefit. A further advantage of borrowing with respect to a life insurance policy would arise if the interest on the policy loan were deductible.

The deductibility of interest on borrowings that relate to life insurance contracts has been limited most recently by tax legislation in 1986, 1996, and 1997.[48] In 1986, deductible interest on borrowings under life insurance contracts was capped at debt of $50,000 per contract, to combat the use of life insurance loans as an "unlimited tax shelter."[49] A pattern then developed of businesses insuring the lives of thousands of their employees to increase the amount of interest to deduct on borrowings under the contracts.[50] In 1996, a broader limitation on deductibility of interest on debt under a life insurance contract was enacted, generally replacing the $50,000 cap. That rule provided that no deduction is allowed for interest paid or accrued on any indebtedness with respect to one or more life insurance, annuity or endowment contracts owned by the taxpayer, and covering the life of any individual who is or has been (1) an officer or employee of, or (2) financially interested in, any trade or business currently or formerly carried on by the taxpayer.[51] A key person insurance exception was provided.

The interest deduction limitation was further expanded in 1997 when Congress became aware of the practice of businesses insuring the lives of customers or debtors (for example, financial institutions insuring the lives of mortgage borrowers while borrowing under the policies, or maintaining other debt, and deducting the interest thereon).[52] The 1997 legislation provided that no deduction is allowed for interest paid or accrued on any debt with respect to a life insurance, annuity or endowment contract covering the life of any individual. It also provided that, for taxpayers other than natural persons, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash values of a life

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[48] Provisions of tax legislation designed to limit the tax arbitrage of deducting interest on borrowings with respect to a life insurance contract date to the 1940's. Section 129 of the Revenue Act of 1942 (Pub. L. No. 753, 77th Cong., 56 Stat. 798) added Internal Revenue Code section 24(a)(6), which provided that no deduction was allowed for "any amount paid or accrued on indebtedness incurred or continued to purchase a single premium life insurance or endowment contract. For the purposes of this paragraph, if substantially all the premiums on a life insurance or endowment contract are paid within a period of four years from the date on which such contract is purchased, such contract shall be considered a single premium life insurance or endowment contract."

[49] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, at 579. *See* Tax Reform Act of 1986, Pub. L. 99-514, sec. 1003, 100 Stat. 2388 (1986).

[50] *See* Lee Sheppard, "'Janitor' Insurance as a Tax Shelter," *Tax Notes,* Sept. 25, 1995, p. 1526.

[51] Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress* (JCS-12-96), Dec. 18, 1996, p. 365. See Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191, sec. 510, 110 Stat. 2090 (1996).

[52] *See* "Fannie Mae Designing a Program to Link Life Insurance, Loans," *Washington Post*, Feb. 8, 1997, p. E3; "Fannie Mae Considers Whether to Bestow Mortgage Insurance," *Wall St. Journal*, April 22, 1997, at C1.

insurance, annuity or endowment contract. An exception is provided under this proration rule for contracts that cover an individual who is a 20-percent owner, officer, director or employee of the taxpayer's trade or business.[53]

2. Tax treatment

Under present law, no deduction is permitted for premiums paid on any life insurance, annuity or endowment contract, if the taxpayer is directly or indirectly a beneficiary under the contract (sec. 264(a)(1)).

In addition, no deduction is allowed for interest paid or accrued on any debt with respect to a life insurance, annuity or endowment contract covering the life of any individual (sec. 264(a)(4)), with a key person insurance exception.[54]

A pro rata interest deduction disallowance rule also applies. Under this rule, in the case of a taxpayer other than a natural person, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash surrender values (sec. 264(f)).[55] Interest expense is allocable to unborrowed policy cash values based on the ratio of (1) the taxpayer's average unborrowed policy cash values of life insurance, annuity and endowment contracts, to (2) the sum of the average unborrowed cash values (or average adjusted bases, for other assets) of all the taxpayer's assets.

Under the pro rata interest disallowance rule, an exception is provided for any contract owned by an entity engaged in a trade or business, if the contract covers only one individual who is a 20-percent owner of the entity, or an officer, director, or employee of the trade or business.

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[53] This proration rule applies to policies issues after June 8, 1997. See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1084, 111 Stat. 951 (1997), and see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997* (JCS-23-97), Dec. 17, 1997, p. 272.

[54] This provision limits interest deductibility in the case of such a contract covering any individual in whom the taxpayer has an insurable interest under applicable State law when the contract is first issued, except as otherwise provided under special rules with respect to key persons and pre-1986 contracts. Under the key person exception (sec. 264(e)), otherwise deductible interest may be deductible, so long as it is interest paid or accrued on debt with respect to a life insurance contract covering an individual who is a key person, to the extent that the aggregate amount of the debt does not exceed $50,000. The deductible interest may not exceed the amount determined by applying a rate based on Moody's Corporate Bond Yield Average-Monthly Average Corporates. A key person is an individual who is either an officer or a 20-percent owner of the taxpayer. The number of individuals that can be treated as key persons may not exceed the greater of (1) 5 individuals, or (2) the lesser of 5 percent of the total number of officers and employees of the taxpayer, or 20 individuals.

[55] This applies to any life insurance, annuity or endowment contract issued after June 8, 1997.

The exception also applies to a joint-life contract covering a 20-percent owner and his or her spouse.

Other interest deduction limitation rules also apply with respect to life insurance, annuity and endowment contracts. Present law provides that no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a single premium life insurance, annuity or endowment contract (sec. 264(a)(3)). In addition, present law provides that no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a life insurance, annuity or endowment contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract (either from the insurer or otherwise) (sec. 264(a)(3)). Under this rule, several exceptions are provided, including an exception if no part of four of the annual premiums due during the initial seven-year period is paid by means of such debt (known as the "4-out-of-7 rule").

Interest deductions under COLI arrangements have also been limited by recent case law applying general principles of tax law, including the sham transaction doctrine. The case of *Winn-Dixie Stores, Inc. v. Commissioner*[56] involved the application of the sham transaction doctrine. In 1993, Winn-Dixie entered into a company-owned life insurance (COLI) program on the lives of its 36,000 employees. Under the program, Winn-Dixie purchased whole-life insurance policies and was the sole beneficiary. Winn-Dixie borrowed periodically against the policies' account value at interest rates that averaged 11 percent. The 11-percent average interest rate, when coupled with the administrative fees, outweighed the net cash surrender value and benefits paid on the policy. Thus, although Winn-Dixie lost money on the program each year, the tax deductibility of the interest and fees yielded a benefit of several billion dollars over 60 years. In 1997, Winn-Dixie terminated its participation in the COLI program following the enactment of tax law changes in 1996 that limited the deductibility of interest on COLI policy loans. On audit, the IRS disallowed the deductions for interest and administrative fees that Winn-Dixie claimed on its 1993 tax return with respect to its COLI program and COLI policy loans.

On petition to the Tax Court, Winn-Dixie argued that the deductions relating to its COLI program were proper because: (1) the COLI program satisfied the business purpose and economic substance prongs of the sham transaction doctrine, and (2) in any case, the sham transaction doctrine was inapplicable because Congress explicitly authorized the deductions in connection with the COLI program. However, the Tax Court sustained the IRS disallowance of the COLI-related deductions claimed by Winn-Dixie, concluding that the COLI program (including the associated policy loans) was a sham.

In arguing that its COLI program had a business purpose and economic substance, Winn-Dixie asserted that it used the earnings from the COLI program to fund the flexible benefits program that it provided to its full-time employees.[57] However, the Tax Court determined that

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[56] *Winn-Dixie,* 113 T.C. 254 (1999), *aff'd* 254 F.3d 1313 (11th Cir. 2001), *cert. denied*, April 15, 2002.

[57] *Winn-Dixie,* 113 T.C. at 286.

the COLI program lost money on a pre-tax basis, and that the program generated positive earnings and cash flow only on an after-tax basis after taking into account the deductions for interest and administrative costs. Thus, the court concluded that the COLI program was a sham:

> Even if we were to accept [the testimony of Winn-Dixie's financial vice president] that he intended to use tax savings to fund [Winn-Dixie's flexible benefits program], that would not cause the COLI plan to have economic substance. If this were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, every sham tax-shelter device might succeed. Petitioner's benefit from the COLI plan was dependent on the projected interest and fee deductions that would offset income from petitioner's normal operations. The possibility that such tax benefits could have been used as a general source of funds for petitioner's [flexible benefits program] obligations (or any other business purpose) does not alter the fact that the COLI plan itself had only one function and that was to generate tax deductions which were to be used to offset income from its business and thereby reduce petitioner's income tax liabilities in each year.[58]

With regard to whether Congress sanctioned the deductibility of interest and costs relating to COLI programs, Winn-Dixie argued that the sham transaction doctrine was not pertinent to its COLI program because Congress has repeatedly addressed the treatment of COLI plans over the years and has permitted deductions attributable to certain COLI plans that either satisfied explicit statutory requirements or predated the enactment of legislation to restrict such deductions.[59] However, the Tax Court concluded that any legislative approval of COLI programs was premised upon programs that had economic substance and were not shams:

> It is clear that Congress and the Treasury Department were aware of the problems associated with interest deductions on life insurance loans. However, we are not persuaded that Congress, by enacting and amending section 264 or other related provisions that restrict the deductibility of interest, intended to allow interest deductions under section 163 based on transactions that lacked with economic substance or business purpose. In *Knetsch*,[60] the Supreme Court noted that nothing in the legislative history of section 264 suggests that Congress intended to protect sham transactions. Similarly, we find nothing in the more recent legislative history of section 264 suggesting that Congress intended to allow deductions arising from sham transactions that lacked economic substance and business purpose.[61]

Accordingly, the Tax Court upheld the disallowance by the IRS of the deductions claimed by Winn-Dixie for interest and administrative costs relating to its COLI program. On

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[58] *Id*. at 287-288 [footnote omitted].

[59] *Id*. at 290.

[60] *Knetsch v. United States*, 364 U.S. 361 (1960) (disallowing deduction for prepaid interest on a nonrecourse, riskless loan used to purchase deferred-annuity savings bonds) (footnote supplied).

[61] *Winn-Dixie,* at 293-294.

appeal, the Eleventh Circuit Court of Appeals adopted the reasoning of the Tax Court and affirmed its decision.[62]

Other recent cases have also upheld the disallowance by the IRS of deductions for interest relating to COLI programs. In *Internal Revenue Service v. CM Holdings, Inc.*,[63] Camelot Music had purchased COLI policies in 1990 covering the lives of 1,430 employees. Camelot borrowed under the policies to pay the first three annual premiums and sought to deduct the interest on the borrowings. Camelot subsequently filed a petition under chapter 11 of the Bankruptcy Code, and the IRS filed proofs of claim based on disallowance of the interest deductions. The court held that the interest deductions should be disallowed, and also concluded that the application of accuracy-related penalties was appropriate. The court stated that there were two rationales for the interest deduction disallowance. First, the interest deductions were part of a transaction that was in part a factual sham and therefore did not meet the "4-out-of-7" exception to the interest deduction disallowance rule of Code section 264(a)(3). In addition, the COLI plan lacked economic substance and business purpose, and was a sham in substance.[64]

In *American Electric Power, Inc. v. U.S.*,[65] the District Court concluded that interest deductions on policy loans under a COLI program covering the lives of over 20,000 employees should be disallowed. The court concluded that the "plan as a whole was a sham in substance,"[66] as well as concluding that first-year policy loans, and the first-year and fourth-through seventh-year loading dividends and corresponding portions of the premiums, were factual shams. The court stated that it had "independently reached many of the same conclusions as the court in *C.M. Holdings*," and that the policies in that case were in all relevant respects identical to those involved in this case.[67]

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[62] 254 F.3d 1313 (11th Cir. 2001) (per curiam).

[63] *Internal Revenue Service v. CM Holdings, Inc.*, 254 B.R. 578 (D. Del. 2000).

[64] *Id.* at 583, 654.

[65] *American Electric Power, Inc. v. U.S.*, 136 F.Supp. 2d 762 (S. D. Ohio 2001).

[66] *Id*. at 795.

[67] *Id*. at 769.

IV. STOCK-BASED COMPENSATION

A. General Description

Stock in the employer is a commonly used form of compensation for employees and may be provided as compensation also for service providers who are not employees, such as outside directors.

Similar to nonqualified deferred compensation arrangements, an employer may have a formal plan that provides stock-based compensation to employees on a regular basis. For example, the employer may have a plan under which stock or stock options are granted to employees annually. Alternatively, or in addition, an individual's employment contract may provide for stock-based compensation for that individual. In some cases, stock-based plans are a means of providing nonqualified deferred compensation.

Stock-based compensation is often used in connection with incentive compensation. For example, bonuses may be paid in the form of stock; grants of stock or stock options may depend on corporate performance; or the rate at which restrictions on stock lapse or the rate at which stock options become exercisable may be accelerated by higher than expected corporate earnings. Some argue that the use of stock-based compensation is an appropriate means of compensation because it aligns the interests of the shareholders and corporate executives and rewards performance. On the other hand, some argue that an increase in stock price or corporate earnings alone is not an appropriate measure of performance because such an increase may not be directly linked to an individual's performance and may encourage executives to inappropriately inflate earnings.

B. Compensatory Stock[68]

1. In general

Stock may be granted to an employee (or other service provider) without restrictions in the sense that the stock is fully vested and transferable. In some cases, the employee is granted "restricted" stock in the sense that the stock must be forfeited or sold back to the company in certain circumstances. For example, an employee may receive stock that is subject to a substantial risk of forfeiture because of a requirement that the stock be forfeited if the employee terminates employment within five years.[69]

2. Tax treatment

Stock that is granted to an employee (or other service provider) is subject to the rules that apply under section 83 to transfers of property in connection with the performance of services. Accordingly, if vested stock is transferred to an employee, the excess of the fair market value of the stock, over the amount, if any, the employee pays for the stock is includible in the employee's income for the year in which the transfer occurs.

If nonvested stock is transferred to an employee, no amount is includible in income as a result of the transfer unless the employee elects to apply section 83 at that time. Otherwise, the excess of the fair market value of the stock at the time of vesting, over the amount, if any, the employee pays for the stock is includible in the employee's income for the year in which vesting occurs.

In the case of an employee, the amount includible in income under section 83 is also subject to income tax withholding and to social security tax (subject to the social security wage base) and Medicare tax and must be reported on a Form W-2.

The amount includible in the income of the employee (or other service provider) is deductible by the employer for the taxable year of the employer in which the recipient's taxable year of inclusion ends.

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[68] Employer stock may be used also in connection with a qualified defined contribution or defined benefit plan. For a discussion of that topic, see Joint Committee on Taxation, *Background Information Relating to the Investment of Retirement Plan Assets in Employer Stock* (JCX-1-02), February 11, 2002.

[69] Stock that is subject to a substantial risk of forfeiture is referred to as nonvested stock; stock that is not (or is no longer) subject to a substantial risk of forfeiture is referred to as vested stock.

C. Compensatory Stock Options

1. In general

A stock option is the right to purchase stock at a specified price (or at a price determined under a specified formula) at a specified time or during a specified period. Stock options granted to employees or other service providers are considered to be compensation for services. There are two general types of compensation-related stock options under the Code: nonqualified options (sec. 83) and statutory options (sec. 421).

Statutory options include incentive stock options (sec. 422) and options provided under an employee stock purchase plan (sec. 423). Nonqualified options are any other options granted in connection with the performance of services.

2. Nonqualified options

The income taxation of a nonqualified option is determined under section 83 and depends on whether the option has a readily ascertainable fair market value when granted. A nonqualified option has a readily ascertainable fair market value if (1) the option is actively traded on an established market, or (2) the option is transferable, it is immediately exercisable in full, the stock subject to the option is not subject to any restriction or condition that has a significant effect on the value of the option, and the fair market value of the option privilege is readily ascertainable. The option privilege is the opportunity to benefit from increases in the value of the stock during the option period without risking capital.

If an individual receives a nonqualified option that has a readily ascertainable fair market value at the time the option is granted, the excess of the fair market value of the option over the amount, if any, paid for the option is includible in the recipient's gross income as ordinary income in the first taxable year in which the option is either transferable or is not subject to a substantial risk of forfeiture (or, if the taxpayer elects, in the taxable year in which the option is granted). No amount is includible in the gross income of the option recipient due to the exercise of the option.

If the nonqualified option does not have a readily ascertainable fair market value at the time of grant, no amount is includible in the gross income of the recipient with respect to the option until the recipient exercises the option. The transfer of stock on exercise of the option is subject to the general rules of section 83. That is, if vested stock is received on exercise of the option, the excess of the fair market value of the stock over the option price is includible in the recipient's gross income as ordinary income in the taxable year in which the option is exercised. If the stock received on exercise of the option is not vested, the excess of the fair market value of the stock at the time of vesting over the option price is includible in the recipient's income for the year in which vesting occurs unless the recipient elects to apply section 83 at the time of exercise.

In the case of an employee, the amount includible in income under section 83 with respect to nonqualified stock options is also subject to income tax withholding and to social security tax (subject to the social security wage base) and Medicare tax and must be reported on a Form W-2.

A compensation expense deduction equal to the amount of ordinary income included in the gross income of the option recipient is allowable to the employer for the taxable year of the employer in which the recipient's taxable year of inclusion ends.

3. Statutory options

(a) In general

Although nonqualified stock options may be provided to any service provider, statutory options may be granted only to employees. Specifically, a stock option granted to an employee does not qualify as a statutory option unless the employee is an employee of the employer at all times during the period that begins on the date of grant and ends on the day three months before the date the option is exercised. For this purpose, the employer may be the corporation granting the option or a parent or subsidiary thereof. The stock subject to a statutory option may be stock of the employer corporation, or of its parent or subsidiary.

(b) Incentive stock options

An incentive stock option (or "ISO") is an option that provides an employee with the right to purchase stock of an employer corporation and that meets the following requirements:

- The option is granted pursuant to a plan that describes the aggregate number of shares that may be issued under options and the employees or class of employees eligible to receive options.
- The option is granted pursuant to a plan that is approved by the shareholders of the employer within 12 months before or after the date the plan is adopted.
- The option is granted within 10 years from the earlier of the date the plan is adopted or the date the plan is approved by the employer's shareholders.
- The option by its terms is not exercisable after the expiration of 10 years from the date of grant (5 years in the case of an option granted to an individual who, at the time the option is granted, owns stock possessing more than 10 percent of the total combined voting power of all classes of stock of the employer).
- The option price is not less than the fair market value of the stock at the time of grant (110 percent of the fair market value in the case of an option granted to an individual who, at the time the option is granted, owns stock possessing more than 10 percent of the total combined voting power of all classes of stock of the employer).
- The option by its terms is not transferable by the recipient and is exercisable during the recipient's lifetime only by the recipient.
- The terms of the option must not provide that the option will not be treated an incentive stock option.

To the extent that the aggregate fair market value of stock with respect to which incentive stock options are exercisable for the first time by any individual during any calendar year (under all plans of the individual's employer) exceeds $100,000, such options are treated as nonqualified options.

(c) Employee stock purchase plans

An employee stock purchase plan is a plan that provides for the granting of options to purchase stock in an employer corporation and that meets the following requirements:

- The plan must provide for grants of options only to employees of the employer.
- The plan must be approved by the shareholders of the employer within 12 months before or after the date the plan is adopted.
- Under the terms of the plan, no employee may receive an option grant if the employee, immediately after such grant, owns stock possessing 5 percent or more of the total combined voting power or value of all classes of stock of the employer.
- With limited exceptions, the terms of the plan must provide for option grants to all employees of the employer (or all employees who are not highly compensated employees).[70]
- The terms of the plan must provide to all option recipients the same rights and privileges, except that the amount of stock that an employee may purchase under an option may bear a uniform relationship to the total compensation of all employees, and the plan may provide that no employee may purchase more than a maximum amount of stock specified by the plan.
- The terms of the plan must provide that the option price is not less than the lesser of 85 percent of the fair market value of the stock at the time of grant or 85 percent of the fair market value of the stock at the time of exercise.
- The terms of the plan must provide than an option may not be exercised after the expiration of 27 months from the date of grant or, if the option price is not less than 85 percent of the fair market value of the stock at the time of exercise, 5 years from the date of grant.
- The terms of the plan must prohibit an option grant that would permit an employee's rights to purchase stock under all employee stock purchase plans maintained by the employer to accrue at a rate that exceeds $25,000 of fair market value of stock, determined at the time of grant, for each calendar year in which the option is outstanding.
- The terms of the plan must provide that an option is not transferable by the recipient and is exercisable during the recipient's lifetime only by the recipient.

Although it is not required by law, it is common for an employee stock purchase plan to provide for an employee's payment of the option price by means of accumulated payroll deductions.

[70] Because an employee stock purchase plan generally must cover all the employees of the employer, it cannot apply only to corporate executives.

(d) Tax treatment of statutory stock options

Income tax treatment

No amount is includable in the gross income of the option recipient on the grant or exercise of a statutory option.[71] No compensation expense deduction is allowable to the employer with respect to the grant or exercise of a statutory option.

If an employee disposes of stock acquired upon exercise of a statutory option, the employee generally is taxed at capital gains rates with respect to the excess of the fair market value of the stock on the date of disposition over the option price, and no compensation expense deduction is allowable to the employer, unless the employee fails to meet a holding period requirement.[72] The employee fails to meet this holding period requirement if the disposition occurs within two years after the date the option is granted or one year after the date the option is exercised. A disposition that occurs prior to the expiration of the applicable holding period(s) (a "disqualifying disposition") does not qualify for capital gains treatment. Instead, the income realized on the disqualifying disposition, up to the spread on the acquisition of the stock, is treated by the employee as compensation received in the taxable year in which the disposition occurs, and a corresponding deduction is allowable to the employer for the taxable year in which the disposition occurs.

Payroll taxes

The application of income tax withholding and social security and Medicare taxes to ISOs and employee stock purchase plans has been the subject of recent administrative guidance.[73]

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[71] For purposes of the individual alternative minimum tax, the transfer of stock on the exercise of an incentive stock option is treated as the transfer of stock pursuant to a nonqualified option.

[72] If the option price under an employee stock purchase plan includes a discount, in the event of a disposition of the stock that is not a disqualifying disposition, or in the event of the employee's death while owning such stock, capital gains treatment does not apply to the entire amount of the proceeds of the disposition. An amount equal to the lesser of (i) the excess of the fair market value of the stock at the time of the disposition or death over the option price, or (ii) the excess of the fair market value of the share at the time of grant over the option price, must be included in gross income for the taxable year in which the disposition or death occurs. The employer is not entitled to a deduction for this amount.

[73] Notice 2001-14, 2001-6 I.R.B. 516; Notice 2001-72, 2001-49 I.R.B. 548; Notice 2001-73, 2001-49 I.R.B. 549; Prop. Treas. Reg. secs. 1.425-1(e)(5)(i), 31.3121(a)-1(k), 31.3306(b)-1(l), and 31.3401(a)-1(b)(15). This guidance deals also with the application of Federal Unemployment Tax Act ("FUTA") tax to ISOs and employee stock purchase plans. FUTA tax applies in a manner similar to social security tax, subject to the FUTA wage base.

No income tax withholding is required with respect to the exercise of an ISO or the acquisition of employee purchase plan stock because no amount is includible in income as a result of the receipt of the stock. In addition, no income tax withholding is required with respect to a disposition of ISO or employee stock purchase plan stock.

For years before 2003, social security and Medicare taxes do not apply to the exercise of an ISO or the acquisition of employee purchase plan stock or to a disposition of ISO or employee stock purchase plan stock. For years after 2002, social security tax and Medicare tax apply to the exercise of an ISO or the acquisition of employee purchase plan stock. The amount that is subject to social security tax (subject to the social security wage base) and Medicare tax is the amount by which the fair market value of the stock received exceeds the amount paid for the stock. Although not specifically addressed in the administrative guidance, it appears that social security and Medicare taxes do not apply to the disposition of ISO or employee stock purchase plan stock.

Under legislation currently pending, payroll taxes would not apply to the receipt or disposition of ISO or employee stock purchase plan stock that occurs after the date of enactment.[74]

4. Accounting for stock options

(a) In general

The accounting rules for treatment of stock based compensation generally are governed by Accounting Principles Board Opinion 25, Accounting for Stock Issued to Employees, ("APB 25") and Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation, ("FAS 123"). FAS 123 is the preferred accounting method, but is not mandatory. If a company accounts for options using APB 25, disclosure of the impact of FAS 123 on the income statement is required.

(b) APB 25 treatment of stock options

APB 25 requires compensation costs for stock-based employee compensation plans to be recognized based on the difference, if any, between the quoted market price of the stock and the amount an employee must pay to acquire the stock. No increase in value is ascribed to the right to purchase the stock at a fixed price for a period of years. Correspondingly, no decrease in value is ascribed to restrictions on the option. The comparison of the market price to the exercise price is generally done on the grant date.[75] The approach is effectively a snapshot of the difference between the market price and exercise price at a specific date.

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[74] Section 301 of H.R. 3762, the Pension Protection Act of 2002, which was passed by the House on April 11, 2002.

[75] An exception applies to certain variable plans, a type of stock option plan that is not very common.

As a result of these rules, generally no compensation cost is recorded in financial statements for stock options issued to employees if the exercise price is equivalent to or greater than the market price on the grant date.

(c) FAS 123 treatment of stock options

FAS 123, issued in 1995, defines a fair value method of accounting for employee stock options. Under FAS 123, except in extremely rare situations, the fair value determination of an option is made on the grant date.

The fair value of stock options is determined using an option-pricing model that takes into account the stock price at the grant date, the exercise price, the expected life of the option, the volatility of the underlying stock and the expected dividends on it, and the risk-free interest rate over the expected life of the option. The fair value of an option estimated at the grant date is not subsequently adjusted for changes, such as in the price of the underlying stock, its volatility, or the life of the option.

The total amount of compensation cost recognized for an award of stock options is based on the number of options that eventually vest. No compensation cost is recorded for options that do not vest. If compensation cost has been recorded in a prior period and the employee does not vest, such cost is reversed in the current period. Once an option vests no reversal of cost is permitted if the option is forfeited or expires.

D. Other Examples of Stock-Based Arrangements

1. In general

Besides actual stock and stock options, compensation may include other arrangements that are based on or related to stock of the employer. To the extent that such an arrangement involves actual stock, the rules of section 83 may apply. However, some arrangements, such as stock appreciation rights and phantom stock plans, involve cash payments based on stock values, rather than actual stock, and are therefore taxed when actually or constructively received.

2. Stock appreciation rights

A stock appreciation right ("SAR") is an arrangement under which the employee has the right to receive the amount of the increase in the value of employer stock during a specified period. The employee receives the increase in value by cashing out or exercising the SAR. For example, the employee may be granted stock appreciation rights with respect to 1,000 shares of employer stock at a time when the stock is valued at $100 a share, and the SAR may be exercisable for three years. As a result, the employee has the right at any time during the three years to receive cash in the amount of the increase in value of 100 shares of stock since the time the SAR was granted. Variations in the terms of an SAR may include limitations on the exercisability of the SAR until (or unless) certain stock value goals are met or allowing the proceeds of the SAR to be paid in the form of stock rather than cash.

Because the employee has the right to receive on request the increase in stock value that has already occurred (i.e., the current increase in stock value), an SAR raises constructive receipt issues. However, under IRS revenue rulings, a substantial limitation on the employee's ability to receive the current increase in stock value results from the fact that the employee must forego the right to benefit from additional increases in stock value during the SAR period (i.e., the employee must surrender a valuable right) in order to exercise the SAR. Therefore, the current increase in stock value is not considered constructively received. The amount received on exercise of the SAR is includible in income at that time.

3. Phantom stock

A phantom stock plan is a deferred compensation arrangement under which deferred amounts and earnings thereon are determined by reference to hypothetical shares of employer stock. The structure of phantom stock plans is discussed in Part I.A.3, above, in connection with nonqualified deferred compensation. Payments made under a phantom stock plan are includible in income when received.[76]

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[76] In some cases, the amounts due under a phantom stock plan may be paid in the form of stock, rather than cash. In such a case, sec. 83 applies to the transfer of stock.