

**PRESENT LAW AND BACKGROUND
RELATING TO EXECUTIVE COMPENSATION**

Scheduled for a Hearing
Before the
SENATE COMMITTEE ON FINANCE
on September 6, 2006

Prepared by the Staff
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INTRODUCTION

The Senate Committee on Finance has scheduled a hearing for September 6, 2006, on issues related to the tax treatment of executive compensation, including issues relating to backdating of stock options. This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of present-law tax rules and issues relating to certain types of executive compensation arrangements, including the \$1 million dollar cap on the deduction for executive compensation, nonqualified deferred compensation, stock-based compensation (including the tax issues relating to backdating stock options), and golden parachute payments.

¹ This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Relating to Executive Compensation* (JCX-39-06), September 5, 2006.

I. EXECUTIVE SUMMARY

Executives are covered by a wide range of compensation arrangements. Executive compensation arrangements may include several employees or may consist of individual agreements between the company and one executive. In addition to typical arrangements such as nonqualified deferred compensation and stock option programs, executive compensation arrangements often allow executives benefits such as the personal use of the company aircraft or an allowance for financial planning. There is no limit to the scope of particular arrangements. This document discusses commonly used executive compensation arrangements, including nonqualified deferred compensation and stock-based compensation. This document does not address the many other forms of executive compensation such as split-dollar life insurance arrangements, corporate-owned life insurance in connection with a corporation's executive compensation arrangements, and individualized arrangements.

In the case of publicly traded companies, the Code imposes a limit on a company's deduction for compensation of certain employees in excess of \$1 million. The limitation applies to the chief executive officer and the four other most highly compensated employees. Performance-based compensation is not subject to the deduction limitation. Studies have indicated that the deduction limitation may have led to some substitution away from salary compensation toward performance-based compensation, but that growth in overall executive compensation has not been reduced.

Nonqualified deferred compensation is a common form of executive compensation. There are several reasons that companies and executives engage in such arrangements. Nonqualified deferred compensation arrangements are not subject to the rules and limitations applicable to qualified employer retirement plans. Congress recently enacted Code section 409A, which provides specific rules for the tax treatment of nonqualified deferred compensation. Prior to the enactment of section 409A, the tax treatment of nonqualified deferred compensation was governed by general tax principles. Several practices had developed that allowed executives deferral of income inclusion, but inappropriate degrees of security and control over amounts deferred. Section 409A was intended to address these practices.

Stock-based compensation is prevalent in executive compensation arrangements. Stock-based compensation includes stock, restricted stock, stock options, stock appreciation rights and phantom stock. The extent to which the use of stock-based compensation is appropriate has been questioned by some. Many believe that executive compensation should be dependent on a company's performance. Others believe that the emphasis on stock-based compensation is inappropriate as it is not directly linked to an individual's performance and may encourage artificial inflation of a company's stock price.

Stock options, in particular, are commonly used for compensation. Recently enacted accounting rules now require stock options to be reflected in financial statements upon the grant of the options. Stock option backdating has received much media attention recently. The SEC and IRS are investigating this practice with respect to many publicly traded companies. There are financial statement, securities and tax law implications of backdating stock options.

II. LIMITATION ON DEDUCTION FOR COMPENSATION IN EXCESS OF \$1 MILLION

A. Present Law

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 corporation² is limited to no more than \$1 million per year (sec. 162(m)).³ 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. Under Treasury regulations, the requirement that the individual meets the criteria as of the last day of the taxable year applies to both the chief executive officer and the four highest compensated officers.⁴

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

² 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.

³ This deduction limitation applies for purposes of the regular income tax and the alternative minimum tax.

⁴ Treas. Reg. sec. 1.162-27(c)(2).

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.

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,⁵ (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

⁵ 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 has to be obtained again in order for the exception to apply to payments under the modified plan.

B. Discussion of Issues

Prior to the enactment of section 162(m) in 1993 (effective for taxable years beginning on or after January 1, 1994), there was no specific limit on the amount of deductible compensation. Section 162 generally limits the deduction for compensation to a "reasonable allowance." While in theory the reasonableness requirement could add as a limit on total compensation paid, this requirement has been applied primarily to prevent dividends of closely-held companies (which are not deductible) from being characterized as compensation (which is deductible).

The legislative history states that section 162(m) was motivated by then-current concerns regarding the amount of *executive* compensation in public companies, and that the purpose of the provision was to reduce "excessive" compensation.⁶ While not specifically mentioned in the legislative history, the exception to the limitation for performance-based compensation reflects the view that such compensation, by its nature, is not "excessive." A provision similar to section 162(m) was also proposed by the Clinton Administration. The rationale behind this provision was stated a bit differently, and focused on the "unlimited tax benefit" provided to executive compensation. This tax benefit was described as particularly inappropriate in cases in which executive compensation increased while company performance suffered. The Administration proposal also had as a stated objective the intent to provide an incentive to link compensation to business performance.⁷ Since the enactment of section 162(m) the appropriateness of executive compensation has remained a topic in the public eye.⁸

Companies may decide to structure compensation arrangements to maximize deductible compensation under section 162(m) or simply to forgo a full compensation deduction. If they decide to maximize the deduction, they may do so in a number of different ways, for example, by providing more deferred compensation or by structuring compensation in a way so that it qualifies as performance based. Literature suggests that these decisions may be affected by a variety of factors including pressure from shareholder groups, the transaction costs involved in changing compensation arrangements, the extent to which the company is already paying compensation that is viewed as high compared to other similar companies, insider ownership, the amount of current tax cost associated with failure to comply (i.e., whether the loss of a deduction

⁶ H.R. Rep. No. 103-111, at 646 (1993). Concerns regarding the amount of compensation paid in non-public companies may also arise, but may present different issues than with respect to public companies.

⁷ Department of the Treasury, *Summary of the Administration's Revenue Proposals* (February 1993), at 40.

⁸ See, for example, Laura Smitherman, *Earning Power: Maryland's Highest-Paid Executives*, Baltimore Sun, June 18, 2006, at 1A; Renee Degross, *CEO Beats Peers in Pay*, Atlanta Journal and Constitution, April 15, 2006, at B1; Shabina S. Khatria, *Who's Winning? (How the battle between shareholder activists and corporate boards over pay policy is shaping up)*, The Wall Street Journal Online, April 11, 2005, at R3; Joann S. Lublin, *Goodbye to Pay for No Performance*, The Wall Street Journal Online, April 11, 2005, at R1.

will have an immediate effect on the tax liability of the company), and the risk characteristics of the executives involved.⁹

According to a number of studies, section 162(m) has not reduced the growth in executive compensation.¹⁰ Some studies indicate that the provision may have increased total compensation. One reason this may occur is that firms may substitute performance-based compensation for fixed salary. Performance-based compensation presents greater risk to the employee, so that an increase in such compensation must more than offset any reduction in fixed compensation. In addition, some companies with fixed compensation below the \$1 million level may have increased compensation because the provision altered perceptions as to what is considered to be an excessive level of compensation.¹¹ Some firms with compensation near the \$1 million limit may have forgone salary increases as a result of the cap.¹² This does not mean, however, that total compensation was reduced.

Studies have also looked at whether section 162(m) has caused a shift away from salary compensation toward performance-based compensation.¹³ A number of studies have found that section 162(m) has caused such a shift, although there are mixed results on the extent of shifting. Some have observed that compensation may be more responsive to factors other than the tax

⁹ Steven Balsam and Jennifer Yin, *Explaining Firm Willingness to Forfeit Tax Deductions under Internal Revenue Code section 162(m): The Million Dollar Cap*, 24(4) *Journal of Accounting and Public Policy*, 300 (2005); Steven Balsam and David H. Ryan, *Response to Tax Law Changes Involving the Deductibility of Executive Compensation: A Model Explaining Corporate Behavior*, 18 *Journal of the American Taxation Association*, 1, 11-12 (Supp. 1996).

¹⁰ Tod Perry and Marc Zenner, *Pay for Performance? Government Regulation and the Structure of Compensation Contracts*, 62(3) *Journal of Financial Economics*, 453 (Dec. 2001); Robert M. Halperin, Young K. Kwon, and Shelley C. Rhoades-Catanach, *The Impact of Deductibility Limits on Compensation Contracts: A Theoretical Examination*, 23 *Journal of the American Taxation Association* 52 (Supp. 2001); Brian J. Hall and Jeffrey B. Leibman, "The Taxation of Executive Compensation" *Tax Policy and The Economy*, James M. Poterba, Ed, v. 14, Cambridge: MIT Press for the NBER, 1 (2000).

¹¹ David G. Harris and Jane R. Livingstone, *Federal Tax Legislation as an Implicit Contracting Cost Benchmark: The Definition of Excessive Executive Compensation*, 77(4) *The Accounting Review* 997 (Oct. 2002).

¹² Nancy L. Rose and Catherine Wolfram, *Regulating Executive Pay: Using the Tax Code to Influence Chief Executive Officer Compensation*, 20(2) *Journal of Labor Economics* S138 (Pt. 2, 2002).

¹³ Tod Perry and Marc Zenner, *Pay for Performance? Government Regulation and the Structure of Compensation Contracts*, 62(3) *Journal of Financial Economics*, 453 (Dec. 2001); Robert M. Halperin, Young K. Kwon, and Shelley C. Rhoades-Catanach, *The Impact of Deductibility Limits on Compensation Contracts: A Theoretical Examination*, 23 *Journal of the American Taxation Association* 52 (Supp. 2001); Brian J. Hall and Jeffrey B. Leibman, "The Taxation of Executive Compensation" *Tax Policy and The Economy*, James M. Poterba, Ed, v. 14, Cambridge: MIT Press for the NBER, 1 (2000); Steven Balsam and David H. Ryan, *Response to Tax Law Changes Involving the Deductibility of Executive Compensation: A Model Explaining Corporate Behavior*, 18 *Journal of the American Taxation Association*, 1, 11-12 (Supp. 1996).

laws and that in some cases complying with section 162(m) is merely a formalization of preexisting practices.

Some studies have noted some possible unintended consequences from section 162(m), even in situations where firms comply with the provision through the use of performance-based compensation. One study found that, to the extent the substitution of fixed compensation by performance-based compensation occurs, firm profits are reduced because the resulting compensation tends to be higher. Firm profits may also be reduced to the extent that firms decide to forgo the tax deduction.¹⁴ In such cases, shareholders may be adversely affected due to decreased profits. One study has noted that one effect of section 162(m) is that executive pay is more adversely affected during periods of very poor corporate performance and less positively affected during period of very high performance, with the result that executives may try to manipulate earnings to provide a more smooth earnings pattern.¹⁵

Issues have been raised as to whether changes to the \$1 million limitation should be made in an effort to provide more effective limitations on excessive compensation. Broad reaching changes are possible. Any changes are likely to raise issues similar to those raised under present law regarding the effects of the change, as well as possibly additional issues.

Some have suggested that the exception for performance-based compensation should be eliminated or at least restricted by a dollar amount. Such proposals are typically motivated by concerns that section 162(m) has had little effect on total executive compensation and that the existing performance-based exception is flawed. For example, the present-law rules have been criticized as overly broad and as merely providing a structure for present practices without causing any greater link between individual performance and compensation.

Some have also noted that, to the extent excessive compensation is a concern, it is not limited to a few executives in public companies. In some cases, the "reasonable compensation" standard may be viewed as not providing sufficient limits on compensation. Thus, some suggest that the scope of the deduction limitation be expanded, for example, to apply to a larger group of executives, all employees of public companies, to all employees (whether or not the employer is publicly traded), or to any individual whose compensation for services provided.

Others have suggested changes to the definition of performance-based compensation within the existing structure of section 162(m) to provide a better link between performance and pay. For example, at least one commentator has suggested that options should be granted with an exercise price that is greater than fair market value at the time of grant and that repricing of

¹⁴ Robert M. Halperin, Young K. Kwon, and Shelley C. Rhoades-Catanach, *The Impact of Deductibility Limits on Compensation Contracts: A Theoretical Examination*, 23 *Journal of the American Taxation Association* 52 (Supp. 2001); Steven Balsam and Jennifer Yin, *Explaining Firm Willingness to Forfeit Tax Deductions under Internal Revenue Code section 162(m): The Million Dollar Cap*, 24(4) *Journal of Accounting and Public Policy* 300 (2005).

¹⁵ Austin Reitenga, Steve Buchheit, Qin Jennifer Yin, and Terry Baker, *CEO Bonus Pay, Tax Policy, and Earnings Management*, 24 *Journal of the American Tax Association* 1 (2002).

underwater options (i.e., options with an exercise price greater than current fair market value) should be restricted.¹⁶

The present-law rules have also raised some issues in terms of scope. As discussed above, under present law, in order to be a covered employee, an individual must have that status on the last day of the year. In some situations, this rule has been applied so that a person who has been, for example, the chief executive officer for all but the last day of the year, is not subject to the provision. Modifications to the definition of covered employee, for example, to apply to anyone who is a covered employee at any time during the year, could address such concerns. In addition, former employees often receive substantial amounts of compensation with respect to services rendered before employment. However, former employees are not subject to section 162(m). To the extent this is a concern, the definition of covered employee could be modified to apply to former employees who had been a covered employee before separation from service.

The SEC has announced new disclosure rules relating to executive compensation, which are scheduled to be effective for fiscal years ending on or after December 15, 2006. Among other things, these new rules change the group of employees whose compensation is required to be disclosed. Section 162(m) should be reviewed in light of these new rules.

¹⁶ Susan J. Stabile, *Does Performance-Based Compensation Positively Affect Managerial Performance?*, 2 University of Penn. Journal of Labor and Employment Law 227 (1999).

III. NONQUALIFIED DEFERRED COMPENSATION

A. General Description

1. In general

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)), simplified employee pensions or "SEPs" (sec. 408(k)), and eligible deferred compensation plans of State or local government employers (sec. 457(b)).¹⁷ For simplicity, these plans are referred to collectively here as "qualified employer plans." A nonqualified deferred compensation arrangement is generally any deferred compensation arrangement that is not one of these qualified employer plans.

The America Jobs Creation Act of 2004¹⁸ added section 409A to the Code which provides specific rules governing the tax treatment of nonqualified deferred compensation.¹⁹ Prior to section 409A, there were not rules that specifically governed the tax treatment of nonqualified deferred compensation. In determining the tax treatment of nonqualified deferred compensation, a variety of tax principles and Code provisions were relevant (as discussed in more detail below). Under section 409A, unless certain requirements are satisfied, amounts deferred under a nonqualified deferred compensation plan are currently includible in income to the extent not subject to a substantial risk of forfeiture. The requirements imposed under section 409A affect that the way that nonqualified deferred compensation arrangements are now commonly structured. These requirements are discussed in more detail below.

¹⁷ 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.

¹⁸ Pub. L. No. 108-357 (2004).

¹⁹ Section 409A generally applies to amounts deferred after December 31, 2004.

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.²⁰

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 many cases, such a simple arrangement might not meet the needs of the parties to the arrangement; thus, the typical nonqualified defined compensation arrangement is more complicated and may involve a funding vehicle or other mechanism to provide security to the employee.

(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. In addition, some stock-based compensation arrangements are forms of nonqualified deferred compensation. For example, see the discussion of phantom stock plans below.

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

²⁰ Before 2005, the tax treatment of nonqualified deferred compensation was generally governed by general tax principles. As discussed more fully below, since 2005, section 409A provides specific rules for nonqualified deferred compensation arrangements, which limits how such arrangements may be structured without current income inclusion.

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 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.²¹ 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.²²

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.”

²¹ The Code definition of “highly compensated employee” (sec. 414(q)) has not been applied for this purpose.

²² 29 CFR 2520.104-23.

(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.²³ 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, nonmanagement 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 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 (\$220,000 for 2006) and the amount of an employee’s annual elective deferrals (\$15,000 for 2006). 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

²³ The limits under sec. 415 apply to qualified defined contribution and defined benefit plans, which generally must be funded.

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 \$15,000 (for 2006), 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.²⁴

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

²⁴ Ineligible plans are also subject to section 409A.

- 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 depend 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 employer 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.²⁵ 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) \$44,000 (for 2006). 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) \$175,000 (for 2006).

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.²⁶ Such 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.²⁷ 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.²⁸

²⁵ Government plans and church plans are generally exempt from some of these requirements.

²⁶ The tax treatment of nonqualified deferred compensation is discussed in detail in Part B, below.

²⁷ Self-employed individuals are generally considered employees for purposes of the rules relating to qualified employer plans.

²⁸ In general, arrangements discussed in this document may apply to individuals who are not employees as well as to employees.

(c) Funding and security

In general

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 employees. Qualified employer plan 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.

Attempts to provide security for nonqualified deferred compensation

In general

As discussed below, to avoid current income inclusion, 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.²⁹ 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.

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.³⁰

²⁹ This risk is not a substantial risk of forfeiture as defined under sec. 83.

³⁰ A rabbi trust is generally a grantor trust of the employer for tax purposes, so trust earnings are treated as income to the employer.

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.³¹ As a result, no amount is included in income by reason of the rabbi trust; generally income inclusion occurs as payments are made from the trust.³²

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.³³ 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).³⁴ 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. As discussed below, section 409A includes rules requiring current income inclusion upon the use of an offshore arrangement or other arrangement contingent on the employer’s financial health. Other funding arrangements are not covered by section 409A and there is little specific guidance as to how these arrangements should be treated for tax purposes. The tax treatment depends on the facts of the particular arrangement.

³¹ 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.”

³² 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.

³³ An offshore rabbi trust has been referred to as a “Rastafarian” rabbi trust. Under section 409A, such arrangement would result in current income inclusion.

³⁴ A secular trust is generally structured as a separate entity for tax purposes, and earnings are includible in the income of the trust.

(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.³⁵ 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).³⁶

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. 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.

³⁵ Governmental plans and church plans are generally exempt from ERISA.

³⁶ Some requirements under ERISA correspond to parallel requirements under the Code.

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. The America Jobs Creation Act of 2004³⁷ added section 409A to the Code which provides specific rules governing the tax treatment of nonqualified deferred compensation.³⁸

Prior to section 409A, there were not rules that specifically governed the tax treatment of nonqualified deferred compensation. A variety of tax principles and Code provisions were relevant, 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)). Section 409A does not override these tax principles and Code provisions. Thus, they are relevant in determining the tax treatment of nonqualified deferred compensation and are discussed below. Section 409A does not prevent the inclusion of amounts in gross income under any provision or rule of law earlier than the time provided under its rules.

(b) Section 409A

Section 409A in general

Under section 409A, all amounts deferred under a nonqualified deferred compensation plan³⁹ for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture⁴⁰ and not previously included in gross income, unless certain requirements are satisfied. If the requirements of section 409A are not satisfied, in addition to current income inclusion, interest at the rate applicable to underpayments of tax plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to a 20-percent additional tax.

³⁷ Pub. L. No. 108-357 (2004).

³⁸ Section 409A generally applies to amounts deferred after December 31, 2004.

³⁹ A plan includes an agreement or arrangement, including an agreement or arrangement that includes one person. Amounts deferred also include actual or notional earnings.

⁴⁰ As under section 83, the rights of a person to compensation are subject to a substantial risk of forfeiture if the person's rights to such compensation are conditioned upon the performance of substantial services by any individual.

Definition of nonqualified deferred compensation plan

For purposes of section 409A, a nonqualified deferred compensation plan is any plan that provides for the deferral of compensation other than a qualified employer plan or any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. A qualified employer plan means a qualified retirement plan, tax-deferred annuity, simplified employee pension, and SIMPLE. A qualified governmental excess benefit arrangement (sec. 415(m)) is a qualified employer plan. An eligible deferred compensation plan (sec. 457(b)) is also a qualified employer plan. A tax-exempt or governmental deferred compensation plan that is not an eligible deferred compensation plan is not a qualified employer plan.

Section 409A does not apply to an arrangement taxable under section 83 providing for the grant of an option on employer stock with an exercise price that is not less than the fair market value of the underlying stock on the date of grant if such arrangement does not include a deferral feature other than the feature that the option holder has the right to exercise the option in the future or to incentive stock options meeting the requirements of 422 or options granted under an employee stock purchase plan meeting the requirements of section 423. Certain other stock-based arrangements may be treated as nonqualified deferred compensation under section 409A.

Permissible distributions

In general

Under section 409A, distributions from a nonqualified deferred compensation plan may be allowed only upon separation from service (as determined by the Secretary), death, a specified time (or pursuant to a fixed schedule), change in control of a corporation (to the extent provided by the Secretary), occurrence of an unforeseeable emergency, or if the participant becomes disabled. A nonqualified deferred compensation plan may not allow distributions other than upon the permissible distribution events and, except as provided in regulations by the Secretary, may not permit acceleration of a distribution.

Separation from service

In the case of a specified employee who separates from service, distributions may not be made earlier than six months after the date of the separation from service or upon death. Specified employees are key employees⁴¹ of publicly-traded corporations.

Specified time

Amounts payable at a specified time or pursuant to a fixed schedule must be specified under the plan at the time of deferral. Amounts payable upon the occurrence of an event are not treated as amounts payable at a specified time.

⁴¹ Key employees are defined in section 416(i) and generally include officers having annual compensation greater than \$130,000 (adjusted for inflation and limited to 50 employees), five percent owners, and one percent owners having annual compensation from the employer greater than \$150,000.

Change in control

Distributions upon a change in the ownership or effective control of a corporation, or in the ownership of a substantial portion of the assets of a corporation, may only be made to the extent provided by the Secretary.

Unforeseeable emergency

An unforeseeable emergency is defined as a severe financial hardship to the participant: (1) resulting from an illness or accident of the participant, the participant's spouse, or a dependent (as defined in sec. 152(a)); (2) loss of the participant's property due to casualty; or (3) other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant.⁴² The amount of the distribution must be limited to the amount needed to satisfy the emergency plus taxes reasonably anticipated as a result of the distribution. Distributions may not be allowed to the extent that the hardship may be relieved through reimbursement or compensation by insurance or otherwise, or by liquidation of the participant's assets (to the extent such liquidation would not itself cause a severe financial hardship).

Disability

A participant is considered disabled if he or she (1) is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months; or (2) is, by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than three months under an accident and health plan covering employees of the participant's employer.

Prohibition on acceleration of distributions

Except as provided in regulations by the Secretary, no accelerations of distributions may be allowed.

Requirements with respect to elections

Section 409A requires that a plan must provide that compensation for services performed during a taxable year may be deferred at the participant's election only if the election to defer is made no later than the close of the preceding taxable year, or at such other time as provided in

⁴² Section 826 of the Pension Protection Act of 2006 (Pub. L. No. 109-280) provides that within 180 days after enactment (the date of enactment was August 17, 2006), the Secretary of Treasury must modify the rules for determining whether a participant has an unforeseeable emergency for purposes of section 409A to provide that if an event would qualify as an unforeseeable emergency if it occurred with respect to the participant's spouse or dependent, such event shall, to the extent permitted under the plan, constitute an unforeseeable emergency if it occurs with respect to a person who is a beneficiary with respect to a participant.

Treasury regulations.⁴³ In the case of any performance-based compensation based on services performed over a period of at least 12 months, such election may be made no later than six months before the end of the service period.

The time and form of distributions must be specified at the time of initial deferral.

A plan may allow changes in the time and form of distributions subject to certain requirements. A nonqualified deferred compensation plan may allow a subsequent election to delay the timing or form of distributions only if: (1) the plan requires that such election cannot be effective for at least 12 months after the date on which the election is made; (2) except in the case of elections relating to distributions on account of death, disability or unforeseeable emergency, the plan requires that the payment with respect to which the election is made is deferred for a period of not less than five years from the date such payment would otherwise have been made; and (3) the plan requires that an election related to a distribution to be made upon a specified time may not be made less than 12 months prior to the date of the first scheduled payment.

Foreign trusts

In the case of assets set aside (directly or indirectly) in a trust (or other arrangement determined by the Secretary) for purposes of paying nonqualified deferred compensation, such assets are treated as property transferred in connection with the performance of services under section 83 (whether or not such assets are available to satisfy the claims of general creditors) at the time set aside if such assets (or trust or other arrangement) are located outside of the United States or at the time transferred if such assets (or trust or other arrangement) are subsequently transferred outside of the United States. Any subsequent increases in the value of, or any earnings with respect to, such assets are treated as additional transfers of property. Interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the amounts set aside been includible in income for the taxable year in which first deferred or, if later, the first taxable year not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to an additional 20-percent tax.

Triggers upon financial health

A transfer of property in connection with the performance of services under section 83 also occurs with respect to compensation deferred under a nonqualified deferred compensation plan if the plan provides that upon a change in the employer's financial health, assets will be restricted to the payment of nonqualified deferred compensation. An amount is treated as restricted even if the assets are available to satisfy the claims of general creditors.

The transfer of property occurs as of the earlier of when the assets are so restricted or when the plan provides that assets will be restricted. Any subsequent increases in the value of, or any earnings with respect to, restricted assets are treated as additional transfers of property.

⁴³ In the first year that an employee becomes eligible for participation in a nonqualified deferred compensation plan, the election may be made within 30 days after the date that the employee is initially eligible.

Interest at the rate applicable to underpayments of tax plus one percentage point is imposed on the underpayments that would have occurred had the amounts been includible in income for the taxable year in which first deferred or, if later, the first taxable year not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to an additional 20-percent tax.

Rules applicable in the case of underfunded defined benefit pension plans

The Pension Protection Act of 2006⁴⁴ amended section 409A by providing that if, during any restricted period with respect to a single-employer defined benefit pension plan of a plan sponsor, assets are set aside (directly or indirectly) in a trust (or other arrangement as determined by the Secretary of the Treasury), or transferred to such a trust or other arrangement, for purposes of paying deferred compensation of an applicable covered employee, such transferred assets are treated as property transferred in connection with the performance of services (whether or not such assets are available to satisfy the claims of general creditors) under section 83. The provision also applies if a nonqualified deferred compensation plan of a plan sponsor provides that assets will be restricted to the provision of benefits under the plan in connection with a restricted period of any defined benefit pension plan of the employer, or assets are so restricted.

A restricted period is (1) any period in which a single-employer defined benefit pension plan of the plan sponsor is in at risk-status,⁴⁵ (2) any period in which the plan sponsor is in bankruptcy, and (3) the period that begins six months before and ends six months after the date any defined benefit pension plan of the plan sponsor is terminated in an involuntary or distress termination.

Covered employees include the chief executive officer (or individual acting in such capacity), the four highest compensated officers for the taxable year (other than the chief executive officer), and individuals subject to section 16(a) of the Securities Exchange Act of 1934. An applicable covered employee includes any (1) covered employee of a plan sponsor; (2) covered employee of a member of a controlled group which includes the plan sponsor; and (3) former employee who was a covered employee at the time of termination of employment with the plan sponsor or a member of a controlled group which includes the plan sponsor.

If an employer provides directly or indirectly for the payment of any Federal, State or local income taxes with respect to any compensation required to be included in income under the rule, interest is imposed on the amount of such payment in the same manner as if the payment were part of the deferred compensation to which it related. In addition to be included in

⁴⁴ Pub. L. No. 109-280 (2006).

⁴⁵ At-risk status is determined under the general funding rules for single-employer defined benefit pension plans. In general, a plan is in at-risk status for a year if, for the preceding year: (1) the plan's funding target attainment percentage, determined without regard to the at-risk assumptions, was less than 80 percent and (2) the plan's funding target attainment percentage, determined using the at-risk assumptions (without regard to whether the plan was in at-risk status for the preceding year), was less than 70 percent.

income, the payment is subject to a 20 percent additional tax. The payment is also nondeductible by the employer.

(c) Other relevant tax principles

In general

As previously discussed, in addition to section 409A, a variety of tax principles and Code provisions may be relevant in determining the tax treatment of nonqualified deferred compensation, 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)). Before the enactment of section 409A, in general, the time for inclusion of nonqualified deferred compensation depended on whether the arrangement was unfunded or funded. If the arrangement was unfunded, then the compensation was generally includible in income when it was actually or constructively received (i.e., when it was paid or otherwise made available). If the arrangement was funded, then it was generally treated as a transfer of property under section 83, and income was includible for the year in which the individual's right to the property was transferable or not subject to a substantial risk of forfeiture. These general rules continue to apply in addition to those under section 409A.

Income inclusion under an unfunded arrangement

As discussed above, if the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received under section 451 (unless earlier income inclusion applies under section 409A).⁴⁶ Income is constructively received when it is credited to an individual's account, set apart, or otherwise made available so that it may be drawn on at any time.⁴⁷ Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. A requirement to relinquish a valuable right in order to make withdrawals is generally treated as a substantial limitation or restriction.

Income inclusion under a funded arrangement

Section 83

In general, an arrangement is considered funded if there has been a transfer of property under section 83. Section 83 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

⁴⁶ Treas. Reg. secs. 1.451-1 and 1.451-2.

⁴⁷ Compensation that is constructively received is includible in income regardless of whether the requirements of section 409A are met.

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.

A transfer of property occurs when a person acquires a beneficial ownership interest in such property. The term “property” is defined very broadly for purposes of section 83.⁴⁸ 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, regardless of whether the arrangement otherwise meets the requirements of section 409A. On the other hand, amounts deferred under an arrangement that meets the requirements of section 409A are generally not includible in income if deferred amounts are payable from general corporate funds that are subject to the claims of general creditors, as such amounts are treated as unfunded and unsecured promises to pay money or property in the future.

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 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. 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.

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.

⁴⁸ Treas. Reg. sec. 1.83-3(e). This definition in part reflects previous IRS rulings on nonqualified deferred compensation.

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.⁴⁹

A concept related to economic benefit is the cash equivalency doctrine.⁵⁰ 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.⁵¹

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).⁵² These provisions apply rules similar to those under section 83.⁵³ 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, regardless whether the arrangement otherwise meets the requirements of section 409A. 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) (unless earlier income inclusion applies under section 409A). 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.

⁴⁹ *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).

⁵⁰ In the case of nonqualified deferred compensation arrangements, these doctrines have largely been codified in the Code provisions discussed herein. 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.

⁵¹ *See, e.g., Cowden v. Commissioner*, 289 F.2d 20 (5th Cir. 1961).

⁵² Secs. 402(b) and 403(c).

⁵³ Although these Code provisions predate the enactment of section 83 in 1969, they were amended at that time to reflect the enactment of section 83.

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.⁵⁴ 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.

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 and reporting

In the case of an employee, 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, amounts includible in income are required to be reported on the employee's Form W-2 for the year includible in income.

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 included in income under section 409A before distribution of such amount, the amount is includible in the employee's income and is subject to income tax withholding⁵⁵ and Form W-2 reporting.

In the case of an individual who is not an employee, nonqualified deferred compensation amounts includible in income are required to be reported in a Form 1099 for the year includible in income. Income tax withholding generally does not apply to such amounts.

⁵⁴ Secs. 404(a)(5), (b) and (d) and sec. 83(h).

⁵⁵ The required income tax withholding is accomplished by withholding income taxes from other wages paid to the employee in the same year.

In connection with the enactment of section 409A, annual reporting to the Internal Revenue Service of amounts deferred is also required. Such amounts are generally required to be reported on an individual's Form W-2 (or Form 1099) for the year deferred even if the amount is not currently includible in income for that taxable year.

(c) Social security and Medicare taxes

The Code provides special rules for applying social security and Medicare taxes to nonqualified deferred compensation of employees.⁵⁶ In general, nonqualified deferred compensation is subject 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 the timing of income inclusion.

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. Under a special rule, amounts deferred under a nonaccount balance plan that are not reasonably ascertainable are not required to be taken into account as wages subject to social security and Medicare taxes until the first date that such amounts are reasonably ascertainable.

In the case of a self-employed individual, nonqualified deferred compensation amounts that are includible in income are also taken into account in determining net earnings from self-employment for social security and Medicare tax purposes unless an exception applies.

⁵⁶ 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.

C. Discussion of Issues

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. Individuals 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. Some may defer compensation in order to provide a future income stream in retirement. Others may want to defer compensation to provide for future expected expenses, such as college expenses for their children.

Employers often use nonqualified 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. In many cases, the desire to accommodate the compensation wishes of an individual that a company wants to attract or retain as an employee may be a sufficient motivating factor to provide a deferred compensation arrangement. In some cases, a company may require the deferral of certain amounts of compensation, e.g., salary in excess of \$1 million, in order to comply with the limitation on the deductibility of compensation in excess of \$1 million.⁵⁷

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 contributions that can be made to a qualified plan and increased the maximum amount of compensation that may be taken into account under a qualified plan, 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

⁵⁷ Sec. 162(m). This limitation is previously discussed in detail in Part II.

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, before the enactment of section 409A, 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 have been substantial limitations on the right to withdraw funds, or (2) in the case of a funded arrangement, the deferred compensation must have been subject to a substantial risk of forfeiture.⁵⁸ As a result of these limitations, individuals covered under nonqualified deferred compensation arrangements faced two main risks: (1) they would not have access to deferred amounts when they want them; and (2) the employer would be unable or unwilling to make the payments.⁵⁹

Prior to the enactment of section 409A, attempts to provide executives with increased access and security with respect to nonqualified deferred compensation led to the development of a variety of techniques (some of which are mentioned above) some of which were based on aggressive positions with respect to the question of whether current income taxation results. For example, ways to increase access included allowing distributions in the event of financial hardship. There is was no clear definition of financial hardship, which allowed considerable flexibility in designing arrangements. Some plans employed a so-called “haircut” approach, which allowed the individual access to funds at any time, with the proviso that a portion of the distribution was forfeited to the employer. Some plans used a 10-percent haircut, but others used varying amounts.⁶⁰ Questions arose as to what is the lowest amount of the “haircut” that would not result in current taxation. Loans based on nonqualified deferred compensation arrangements were also used to increase access to deferred amounts. Other efforts to provide security without causing current taxation included 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 was to have a trigger mechanism that results in distributions before the event

⁵⁸ As discussed, these tax principles apply in addition to section 409A.

⁵⁹ Access issues could arise, for example, if the individual had unanticipated financial needs before the payments are scheduled to begin. Issues regarding the employer’s ability or willingness to make payments could arise, for example, if the employer entered bankruptcy, if the employee fell out of favor with management, or in the case of a change in control of the employer. In these circumstances, the employee has a contractual right to receive the nonqualified deferred compensation, but the contractual right may be difficult to enforce.

⁶⁰ 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.

giving rise to the risk of nonpayment occurs. For example, payment could be triggered upon the occurrence of certain financial events that indicated a possible financial downturn for the employer. The means that could be developed to try to increase access and security under nonqualified deferred compensation arrangements, without causing current income inclusion, were probably endless. While some arrangements may have provided the desired tax consequences, in other cases the proper tax treatment was unclear.

Congress was concerned with the practices that had developed which, in some cases, allowed improper deferral of income.⁶¹ As previously discussed, while the general tax principles governing deferred compensation were well established, the determination whether a particular arrangement effectively allowed deferral of income was generally made on a facts and circumstances basis and there was limited specific guidance with respect to common deferral arrangements. The Congress believed that it was appropriate to provide specific rules regarding whether deferral of income inclusion should be permitted. The Congress believed that certain arrangements that allow participants inappropriate levels of control or access to amounts deferred should not result in deferral of income inclusion and that certain arrangements, such as offshore trusts, which effectively protect assets from creditors, should be treated as funded and not result in deferral of income inclusion. Section 409A was enacted to address these concerns. As previously discussed, the requirements imposed under section 409A affect that the way that nonqualified deferred compensation arrangements are now commonly structured.

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.

⁶¹ The Joint Committee staff made recommendations in the nonqualified deferred compensation area following its investigation of Enron Corporation. See Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCS-3-03), February 2003.

IV. STOCK-BASED COMPENSATION

A. General Description

Stock in the employer is a commonly used form of compensation for employees and may also be provided as compensation 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.

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.

In some cases, stock-based plans are a means of providing nonqualified deferred compensation and may be subject to the rules under section 409A. For example, discounted stock options (i.e., options granted at a price lower than the fair market value of the stock on the date of grant) are nonqualified deferred compensation and subject to the rules under section 409A previously discussed.

B. Compensatory Stock⁶²

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.⁶³

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. In the case of an individual who is not an employee, the amount includible in income under section 83 must be reported on a Form 1099.

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

⁶² 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.

⁶³ 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 (which is generally not the case), 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 (which is generally the case), 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. In the case of an individual who is not an employee, the amount includible in income under section 83 must be reported on a Form 1099.

A compensation expense deduction equal to the amount of ordinary income included in the gross income of the option recipient is generally 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).⁶⁴
- 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 that 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.

⁶⁴ Because an employee stock purchase plan generally must cover all the employees of the employer, it cannot apply only to corporate executives.

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.

(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.⁶⁵ 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.⁶⁶ 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

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 includable 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.⁶⁷ No income tax withholding is required when compensation is recognized in connection with an employee stock purchase plan discount.⁶⁸

⁶⁵ 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.

⁶⁶ 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, is treated as ordinary income for the taxable year in which the disposition or death occurs. The employer is not entitled to a deduction for this amount.

⁶⁷ Sec. 421(b).

⁶⁸ Sec. 423(c).

Specific exclusions from FICA and FUTA wages apply for remuneration on account of the transfer of stock pursuant to the exercise of an incentive stock option or under an employee stock purchase plan, or any disposition of such stock.⁶⁹ Thus, social security and Medicare taxes do not apply upon the exercise or disposition of a statutory stock option.

4. Accounting for stock options

The accounting rules for the treatment of stock-based compensation, including stock options, are governed by Statement of Financial Accounting Standards No. 123(R), Share-Based Payment (“FAS 123(R”).⁷⁰ FAS 123(R) is a revision of Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation, (“FAS 123”) and superseded Accounting Principles Board Opinion 25, Accounting for Stock Issued to Employees, (“APB 25”).⁷¹ FAS 123(R) was issued in response to concerns that the methods under APB 25 did not result in an accurate representation of the economic transaction of granting stock options. There was also concern that stock-based compensation should be accounted for using one method (rather than allowing companies to use either APB 25 or FAS 123 as previously allowed). The rules under FAS 123(R) are also more consistent with those under International Financial Reporting Standards. In most cases, accounting for stock options under FAS 123(R) results in a greater compensation expense that would be required under APB 25.

FAS 123(R) generally requires companies to measure compensation costs based on the grant-date fair value of the award.⁷² The objective is to measure the fair value at the grant date that the entity is required to issue when the employees have rendered the requisite service and satisfied any other conditions necessary to earn the right to exercise the options. The grant-date value of employee stock options must be estimated using option-pricing models that take into account the exercise price of the option, the expected option term, the current price of the

⁶⁹ Secs. 3121(a)(22) and 3306(b)(19).

⁷⁰ FAS 123(R) is effective for all companies for reporting periods that begin after December 31, 2005. An earlier effective date applied to certain public companies.

⁷¹ Prior to the effectiveness of FAS 123(R), the accounting rules for treatment of stock-based compensation generally were governed by APB 25 and FAS 123. FAS 123 was the preferred accounting method, but was not mandatory. If a company accounted for options using APB 25, disclosure of the impact of FAS 123 on the income statement was required. APB 25 required 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 was ascribed to the right to purchase the stock at a fixed price for a period of years. Correspondingly, no decrease in value was ascribed to restrictions on the option. The approach was effectively a snapshot of the difference between the market price and exercise price on the grant date (except in the case of certain variable option plans). Under APB 25, generally no compensation cost was recorded in financial statements for stock options issued to employees if the exercise price was equivalent to or greater than the market price on the grant date. Like FAS 123(R), FAS 123 defined 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 was made on the grant date.

⁷² Certain limited exceptions apply.

underlying shares, expected volatility of the price of the underlying shares, expected dividends, and the risk-free interest rates for the expected term of the option. FAS 123(R) allows the use of any option-pricing model that meets its requirements. Acceptable models include the binomial option-pricing model (a lattice model) and the Black-Scholes-Merton option pricing formula (a closed-form model). The estimate is determined as of the grant date and is not remeasured in subsequent periods.

The cost must be recognized over the period during which the employee is required to provide service in exchange for the award (usually the vesting period). 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 (i.e., if the requisite service is not rendered). 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 was forfeited or expired. Thus, under 123(R), options can expire worthless and still result in an expense for the employer.

If an equity award is modified after the grant date, incremental compensation cost is required to be recognized in an amount equal to the excess of the fair value of the modified award over the fair value of the original award before the modification.

FAS 123(R) also requires any excess tax benefits to be recognized (i.e., any excess of the deduction for tax purposes over the compensation cost recognized on the income statement must be reported).

FAS 123(R) also requires expense recognition of employee stock purchase plan options if certain criteria are not met. Under such criteria, any purchase discount may not exceed the per-share amount of share issuance costs that would have been incurred to raise a significant amount of capital by a public offering. A discount of five percent or less is deemed to satisfy this condition.⁷³ Thus, expense recognition of employee stock purchase plan options may be required in the case of discounts in excess of five percent.

5. Backdating stock options

Recent press reports have focused on the issue of backdating stock options.⁷⁴ The SEC is investigating several companies regarding this practice. In addition, the IRS has announced that it is examining the tax issues relating to backdating stock options for several public companies.

Backdating stock options refers to the practice of backdating the grant date so that the price of the stock on the new (backdated) grant date is lower than the price on the actual date of grant.⁷⁵ Because in most cases the exercise price of the option is determined as of the grant date,

⁷³ Code section 423 allows a discount up to 15 percent.

⁷⁴ The issue of backdating stock options has been the subject of recent academic research. See Erik Lie, *On the Timing of CEO Stock Option Awards*, 51 MGMT. SCI. 5 (May 2005) at 802-812.

⁷⁵ Backdating the grant date appears to be the most common practice relating to backdating stock options. However, it appears that some companies have backdated the exercise date of the option.

this results in a lower exercise price and the potential for more gain upon the exercise of the option. In the case of an increasing stock price, backdating results in an automatic option gain at the time of grant (generally referred to as an option that is “in the money”).

Backdating stock options is not itself illegal, but there are several financial statement and securities and tax law implications. If the option backdating is adequately documented and disclosed and the stock options are properly accounted for and properly treated for tax purposes, the backdating may raise no legal issues. Issues arise when the appropriate requirements are not complied with.⁷⁶

There are several tax law implications of backdating stock options. These include the rules for incentive stock options, the \$1 million limitation on the deductibility of compensation, and nonqualified deferred compensation. The tax issues relate to whether the backdated stock option is treated correctly for tax purposes.

As previously discussed, in order to qualify as an incentive stock option, the option exercise price must not be less than the fair market value on the date of grant.⁷⁷ If the grant date of an option is backdated, this requirement is not satisfied and the option would not qualify as an incentive stock option. In the case of a backdated stock option that originally qualified as an incentive stock option, the option would have to be reclassified as a nonqualified stock option and would be subject to the tax treatment under section 83.

As previously discussed, an exception from the \$1 million limitation on deductibility of compensation of certain individuals exists for performance-based compensation.⁷⁸ Compensation attributable to a stock option is deemed to satisfy the performance-based requirement if (in addition to other requirements) the amount of compensation the employee could receive is based solely on an increase in the value of stock after the date of grant or award.⁷⁹ In the case of an option granted with an exercise price that is less than the fair market value of the stock at the date of grant, none of the compensation under the grant is qualified performance-based compensation.⁸⁰ Thus, an option granted at less than fair market value on the actual grant date would generally not qualify under the exception and compensation attributable to the stock option would be subject to the \$1 million limitation. This could result in the loss of the company’s deduction for compensation attributable to the stock option. Section 162(m) also

⁷⁶ Most of the stock option backdating reported in the press appears to have been done prior to the enactment of the Sarbanes-Oxley Act of 2002. Section 403 of Sarbanes-Oxley requires grants of stock options to be reported within two days of grant. The two-day reporting requirement may make stock option backdating more difficult.

⁷⁷ Sec. 422. The price must be 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.

⁷⁸ Sec. 162(m).

⁷⁹ Treas. Reg. sec. 162-27(e)(2)(vi).

⁸⁰ Id.

requires that in the case of a stock option plan, the shareholders must approve the specific terms of the plan. If the option backdating is inconsistent with the terms of the shareholder-approved stock option plan, the shareholder approval requirement would not be satisfied.

Another tax issue relates to the rules under section 409A governing the tax treatment of nonqualified deferred compensation. An option with an exercise price that is not less than the fair market value of the stock at the date of grant is not considered nonqualified deferred compensation under section 409A and is not subject to its requirements.⁸¹ An option with an exercise price below the fair market value of the stock at the date of grant is subject to the rules under section 409A.⁸² Thus, a backdated option would likely be treated as a nonqualified deferred compensation arrangement under section 409A and be subject to the requirements of section 409A, such as the timing of deferral elections and restrictions on when nonqualified deferred compensation can be paid. A backdated stock option is likely to violate these requirements. In that case, the individual would be subject to current income inclusion, a 20-percent additional tax, and interest (if any) at the rate applicable to underpayments of tax plus one percentage point. As previously discussed, section 409A is effective for amounts deferred after December 31, 2004. Most of the stock option backdating that has been reported in the press may have been done prior to the effectiveness of section 409A.

⁸¹ Prop. Treas. Reg. sec. 1.409A-1(b)(5).

⁸² An option with an exercise price lower than the fair market value at the date of grant is commonly referred to as a discounted option.

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 issued before the enactment of section 409A, 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. Under these rulings, 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 unit

A phantom stock unit is a contractual obligation of the company equal in value to one share of the company which, until paid, is an unfunded bookkeeping credit on the records of the company. Upon the vesting of phantom stock units, the holder is generally entitled to payment in cash or in shares of common stock at the rate of one share of common stock for each phantom stock unit, plus dividends that have accrued from the grant date until vesting. Payments made in cash under a phantom stock plan are includible in gross income and wages when received. Payments made in the form of stock are includible in income as provided under section 83. The structure of phantom stock plans is discussed in Part III.A.3., above, in connection with nonqualified deferred compensation.

E. Discussion of Issues

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.

Many companies believe that a great portion of executive compensation should be dependent on company performance. While some argue that linking shareholder and executive success is beneficial for shareholders, conflicts may arise. Linking compensation of executives to the performance of the company can result in executives taking measures to increase short-term earnings instead of focusing on longer-term profitability and growth or to artificially inflate earnings.

Stock options have become a very prevalent form of compensation. Before the effectiveness of FAS 123(R), many companies preferred the use of stock options because of the favorable accounting treatment under APB 25 (i.e., no compensation cost was required to be recorded in financial statements for stock options issued to employees if the exercise price was equivalent to or greater than the market price on the date of grant). Some have speculated that mandatory stock option expensing under FAS 123(R) will cause many companies to modify their compensation arrangements so that there is less emphasis on stock options. Others believe that use of stock options will remain prevalent especially as a means to meet the performance-based compensation exception to the \$1 million deduction limitation.

As previously discussed, the issue of backdating stock options has received much attention recently. While backdating stock options is not per-se illegal, several accounting, securities and tax law issues are involved. The SEC and IRS are investigating stock option backdating practices of many public companies. Many believe that the provisions of the Sarbanes-Oxley Act of 2002 and recently issued SEC executive compensation disclosure rules will make stock option backdating more difficult in the future. In addition, the tax treatment under section 409A may also make stock option backdating less advantageous in the future.

V. 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 (“acquired 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 payable by the acquired corporation and includible in the 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 an 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.