

Executive Compensation Planning

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Overview

- Update on recent legislation – the American Jobs Creation Act of 2004
- Review of executive compensation vehicles
- Implications and planning opportunities with respect to executive compensation under JAGTRRA and AJCA
- Recent court and administrative developments

Key Compensation & Benefits Provisions of AJCA

- Fundamental changes to nonqualified deferred compensation (NQDC) plans
- Permanent withholding relief for incentive stock options (ISOs) and options under a Section 423 employee stock purchase plan
- Limitation of deduction for personal use of employer-provided airplanes
- Increased withholding on supplemental compensation

3

NQDC – Prior Law

- NQDC that is unfunded is not includible in income until paid or otherwise made available to the employee, even if the deferred compensation is vested
- The use of a rabbi trust does not cause NQDC to be considered funded
- Elections to defer compensation could generally be made at any time prior to when the compensation is payable

4

NQDC – Prior Law

- Payment of deferred compensation can be accelerated upon specified events or at any time if early payment is subject to a penalty or other substantial limitation (“haircut”)
- Rodeferrals and changes in the form of payment generally are not limited

5

NQDC – New Law (Section 409A)

- “Nonqualified deferred compensation” is any plan that provides for the deferral of compensation other than:
 - A qualified employer plan
 - A bona fide vacation leave, sick leave, disability pay, or death benefit plan
 - Nonqualified stock options with an exercise price not less than FMV on date of grant (if there is no deferral feature other than the right to exercise the option in the future)
 - ISOs and ESPP options
 - Restricted property the taxation of which is governed by Section 83
- No need for employer/employee relationship for 409A to apply

6

NQDC – New Law

- NQDC **does** include:
 - Discounted nonstatutory options
 - Elective deferred compensation
 - Programs that allow deferral of option income
 - Stock appreciation rights (SARs)
 - Nonelective deferred compensation, such as SERPs
 - Restricted stock units and phantom stock

7

NQDC – New Law

- NQDC generally will be taxable to employee when there is no substantial risk of forfeiture UNLESS:
 - Cannot be distributed earlier than: separation, disability, death, specified time or pursuant to a fixed schedule, change in control (as provided by regulations), or unforeseeable emergency
 - “Key employees” of public companies must wait six months after separation from service for a distribution or at earlier death
 - No acceleration of the time or schedule is allowed, except under limited circumstances to be provided by regulations

8

NQDC – New Law

- An election to defer compensation generally must be made no later than the end of the plan year prior to the year when the related services are to be performed
- Exception for “performance-based compensation” based on services performed over a period of at least 12 months. The election can be made any time prior to six months before the end of the service period
- “Performance-based compensation” will be defined by Treasury based on Section 162(m)-like principles

9

NQDC – New Law

- Time and form of benefit payment must be specified at the time of the initial deferral
- Subsequent elections to delay payment or to change the form of payment cannot take effect for at least 12 months and must be made at least 12 months prior to first scheduled payment. Any redeferral must be for at least 5 years, except for distributions on account of death, disability and unforeseeable emergency.

10

NQDC – New Law

- Setting aside NQDC assets directly or indirectly in a trust (or other arrangement as determined by the Secretary) *outside* the U.S. will result in immediate taxation
- NQDC plan that provides that upon a change in the employer's financial health, assets will be restricted to the payment of benefits (including the funding of a rabbi trust) will result in immediate taxation

11

NQDC – New Law

- If the requirements of the law are not satisfied:
 - Current income inclusion
 - Employee required to pay interest at the underpayment rate plus one percentage point on the underpayment that would have occurred had the amounts been includible in income in the year of deferral
 - Employee will incur a 20% penalty on the amount required to be included in income
 - Penalty may apply even if tax was not deferred
 - Section 409A does not affect the timing of employer's deduction

12

NQDC – New Law

- General effective date:
 - Amounts deferred in taxable years beginning after 2004
 - Earnings on pre-2005 deferrals are subject to the new law to the extent that the amounts deferred are subject to the new law

13

NQDC – New Law

- Grandfather provisions:
 - Amounts deferred pre-2005 are subject to the new law only if the plan is materially modified after October 3, 2004
 - Redeferral of pre-2005 deferrals are allowed in accordance with the plan as in effect on October 3
 - The addition of any benefit, right, or feature is a material modification – e.g., accelerated vesting

14

NQDC – New Law

- Grandfather provisions:
 - A deferral is a pre-2005 deferral only if it is both earned **and** vested before 2005
 - **Caveat:** Do **not** accelerate vesting of unvested deferrals earned before 2005 to try to take advantage of the grandfather provisions – such an acceleration is a material modification and, thus, will cause even the vested pre-2005 deferrals to lose the protection of the grandfather provisions

15

NQDC – New Law

- IRS is directed to issue guidance within 60 days for plans adopted prior to 2005 to provide a limited period in which the plans:
 - Can be amended to permit termination of participation or cancellation of outstanding deferral elections
 - Can be amended to conform to the new law with respect to amounts deferred after 2004

16

NQDC – New Law

- Informal Treasury Guidance
 - Transition issues
 - Documentary compliance by end of 2005
 - IRS will aggressively review deferrals under prior law
 - Elections for 2005 bonuses
 - “Do what you’ve always done; no-lose proposition”

17

ISO and ESPP Withholding Relief

- Exclusions from FICA and FUTA wages provided for the spread upon exercise of an ISO or ESPP option
- Exclusion from federal income tax withholding for disqualifying disposition of ISO or ESPP stock
- Exclusion from federal income tax withholding when compensation is recognized with respect to an ESPP discount
- Options exercised after date of enactment

18

Personal Use of Company Airplanes

- *Sutherland Lumber* case overturned:
 - Employer's deduction for a specified employee's personal use of an employer-provided airplane would be limited to the amount includible in the employee's income
 - A specified employee is an individual who is subject to the requirements of 16(a) of the 1934 Securities Act OR who would be subject to those requirements if the employer or service recipient were an issuer of securities referred to in Section 16(a)
 - Applies to expenses incurred after the date of enactment

19

Increased Withholding on Supplemental Payments

- Once annual supplemental wage payments to an employee exceed \$1 million, any additional supplemental wage payments to the employee in that year are subject to withholding at the highest income tax rate (35 percent for 2004 and 2005), regardless of any other withholding rules and regardless of the employee's Form W-4.

20

Executive Compensation Vehicles

- Nonqualified deferred compensation
 - Rabbi trusts
 - Deferred stock options
 - Investment control
 - Was not restricted by AJCA
- Restricted stock
 - 83(b) elections
- Incentive stock options
 - AMT
- Nonqualified stock options
 - Premium options are not subject to 409A
- Stock appreciation rights
- Phantom stock, restricted stock units, incentive compensation

21

Cutting Edge Executive Compensation Vehicles

- Deep in the money options – killed by 409A
- Deferral of stock option gains – killed by 409A
- Second deferral elections – subject to 409A
- Nonrecourse debt to purchase stock or exercise options

22

- **Withholding and estimated tax**
 - Retroactive change in supplemental and backup withholding rates
 - Backup 28% (from 30%), supplemental 25% (from 27%)
 - Accounting implications
- **Ordinary tax rate changes**

23

- **Prior law rate**
 - Ordinary income tax rates, as high as **38.6%**
- **JAGTRRA**
 - New capital gains rate for “qualified” dividends
 - **15%** (5% for taxpayers with income in lower brackets; 0% in 2008)
 - Prior law applies for tax years after December 31, 2008

24

- Prior law rate
 - **20%** (10% for taxpayers in 10% and 15% brackets)
- JAGTRRA
 - Long-term capital gains rate reduced to **15%** (5% for taxpayers with income in the 10% and 15% brackets; 0% in 2008)
 - Executive compensation
 - 83(b) election
 - Ordinary vs. capital gain
 - Incentive stock options

AMT Exposure

Adjustments and Preferences That Will Cause AMT to Apply

REGULAR TAXABLE INCOME	JOINT			
		PRE- JAGTRRA	POST JAGTRRA	
	2002	2003	2003	2004
50,000	27,064	26,718	34,172	34,099
100,000	28,987	28,641	29,618	29,060
150,000	28,159	27,716	25,420	24,734
200,000	27,239	26,436	21,962	20,759
300,000	27,239	26,436	16,247	15,045
400,000	59,499	57,863	23,956	21,942
500,000	97,356	95,720	48,956	46,942

ANALYSIS ASSUMES ORDINARY INCOME, NO CAPITAL GAIN OR QUALIFYING DIVIDENDS

AMT Exposure

Adjustments and Preferences That Will Cause AMT to Apply

REGULAR TAXABLE INCOME	SINGLE			
		PRE-	POST	
		JAGTRRA	JAGTRRA	
	2002	2003	2003	2004
50,000	23,622	23,414	26,083	25,783
100,000	25,918	25,650	24,690	24,323
150,000	23,419	22,803	18,766	17,902
200,000	24,682	24,110	17,762	16,959
300,000	41,977	41,263	21,684	20,681
400,000	78,927	77,584	45,831	44,317
500,000	116,784	115,442	70,831	69,317

ANALYSIS ASSUMES ORDINARY INCOME, NO CAPITAL GAIN OR QUALIFYING DIVIDENDS

27

- Nonqualified deferred compensation
 - Deferring compensation under a NQDC plan may still be better on a net after-tax basis
- Enhances the appeal of a Section 83(b) election for restricted stock
 - Capital gain on any appreciation after the date of transfer
 - Dividends paid before vesting (and that would otherwise have been taxable at ordinary income rate) taxable at 15% (or lower rate)
 - Risks associated with Section 83(b) election still applicable
- Incentive stock options
 - Use may become more attractive due to lower capital gain taxes
 - Increased exposure to AMT
 - AMT credit use lessened

28

Nonqualified Deferred Compensation Analysis

- Executive in 35% bracket can defer \$1 million until 2011
- Deferral assumptions:
 - 39.6% rate in 2011 and 15% rate extended until then; earns 8%
 - \$1 million compounded at 8% for 7 years = \$1,713,824
 - Balance after 39.6% tax = \$1,035,149
- Pay tax upfront alternative:
 - Net after payment of 35% tax = \$650,000
 - \$650,000 compounded at 8% for 7 years = \$1,113,986
 - Balance after 15% LTCG tax = \$1,044,388
- Under these assumptions, better off not deferring:
 - More flexibility in investing; can transfer assets to children for 5% tax
 - Avoids employer creditor risk; can defer liquidation more easily
- Qualified plan issues may be different

29

Recent Court and Administrative Developments

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Swap of Compensatory Warrants in Merger Not Taxable

- PLR 200418017
 - Compensatory warrants of target swapped for purchaser's warrants not taxable
 - Neither warrant had a readily ascertainable FMV
 - Analogy to swap of restricted property for restricted property
 - Presumably still valid after AJCA, i.e., not a subsequent deferral

31

Deduction for Amount Includible (Not Included)

- James G. Robinson et ux v. US, 335 F.3d 1365, July 15, 2003
- Court of Appeals for Federal Circuit holds that value of property includible in income is deductible by employer regardless of reporting or withholding
- Regulation held invalid
- US Supreme Court certiorari denied by US v. Robinson, 124 S. Ct. 1044, (1/12/04)

32

Frivolous Arguments Concerning NQSOs and ISOs

- Notice 2004-28 says the IRS will challenge positions taken with respect to NQSOs and ISOs
 - Taxation at date of grant
 - FMV reduction due to lapse restriction
 - Ordinary loss on margin call
 - Borrowed funds used to exercise option not an exercise

33

Reduction in Principal Amount of Note Issued to Purchase Stock

- Rev. Rul. 2004-37 says that section 83 trumps section 108
 - Section 108 says that COD reduces basis of purchased property
 - Section 83 says COD is compensation income

34

Stock Options

- **IRS proposes comprehensive rules on Incentive Stock Options (ISOs)** – REG 122917-02
 - Entity classified as a corporation for federal tax purposes may grant ISOs
 - Clarify standards for stockholder approval requirement
 - Guidance on modification, extension, or renewal of options
- **IRS issues guidance on transfers of compensatory stock options to related persons** – Notice 2003-47, TD 9067, and REG 116914-03
 - Employee sells option to related person at fair market value for note
 - IRS will not respect sales where related entity is not bona fide, lacks substance, or lacks a business purpose
 - Identified as a listed transaction
 - Under temporary and proposed regulations, disposition of option to related person automatically not considered arm's length

35

IRS Audit Initiative

- **Nonqualified deferred compensation**
 - Constructive receipt
 - Economic benefit
 - Offshore funding
 - **Loans**
- **Stock based compensation**
 - Vesting
 - Disqualifying dispositions
 - Shareholder approval
 - Withholding (Field directive)
- **Section 162 (m)**
 - Compliance
 - Performance based compensation

36

IRS Audit Initiative

- Golden parachutes
 - Proper calculations
 - Option valuations
 - Non-competes
- Fringe benefits
 - Proper inclusion

37

Hot Topics in the Taxation of Executive Compensation

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Tax Alert

10/07/2004

Compensation and Benefits

American Jobs Creation Act Targets Executive Compensation--- Employers Must Review Their Arrangements Immediately

On October 6, House and Senate conferees reached final agreement on a \$138 billion tax package (the American Jobs Creation Act of 2004) that would repeal the foreign sales corporation (FSC)/extraterritorial income exclusion (ETI) provisions of the Internal Revenue Code. Contained in this tax package are numerous provisions that would significantly impact executive compensation arrangements, including:

- Fundamental changes to nonqualified deferred compensation ("NQDC") plans;
- Limitation of deduction for personal use of employer-provided airplanes;
- Permanent withholding relief for incentive stock options ("ISOs") and options under a Section 423 employee stock purchase plan ("ESPP"); and
- Increase in withholding for supplemental wage payments in excess of \$1 million.

Treatment of NQDC plans

Under current law, if a NQDC arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received. 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. Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Currently, elections to defer compensation can generally be made at any time prior to when the compensation is payable. In addition, payment of NQDC can be accelerated upon specified events or at any time if the early payment is subject to a penalty or other substantial limitation. Furthermore, redeferrals and changes in the form of payments generally are not limited.

The proposal would impose numerous requirements on NQDC plans. If the requirements are not satisfied, all compensation deferred under the plan is includible in a participant's gross income to the extent the compensation is not subject to a substantial risk of forfeiture. In addition, the participant would be required to pay interest at the underpayment rate plus one percentage point and would incur a 20% penalty on the amount required to be included in income. If a particular requirement affects only some of the plan participants, then current income inclusion, interest, and the additional tax apply only with respect to those participants.

Under the proposal, compensation deferred under a NQDC plan generally could not be distributed earlier than separation from service, disability, death, a specified time or pursuant to a fixed schedule, or an unforeseeable emergency. The acceleration of distributions are not allowed (except as provided by regulations). A distribution upon a change in the ownership or effective control of the employer may only be allowed as provided by IRS regulations. For key employees of a publicly traded company, there is a six-month waiting period for any distribution made on account of any separation from service.

In addition, the proposal would require an initial election to defer compensation for services under a NQDC plan to be made in a year prior to the year in which the related services were

performed. For bonuses that relate to services provided over one or more years, this provision seemingly would require any deferral election with respect to such bonuses to be made in advance of any of the services being performed. However, 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 IRS is directed to issue regulations defining performance-based compensation for this purpose to be compensation that is (1) variable and contingent on the satisfaction of preestablished organizational or individual performance criteria, and (2) not readily ascertainable at the time of the election. The requirements are intended to be similar to those under Section 162(m) with respect to the \$1 million deduction limit.

An election can be made to delay the timing or change the form of distributions. However, such an election cannot take effect for at least 12 months and must be made at least 12 months prior to the first scheduled payment. Any redeferral must be for at least five years.

The proposal would also restrict the use of offshore trusts as a funding mechanism for NQDC plans. Under the bill, assets that are set aside directly or indirectly in an offshore trust generally are considered property transferred in connection with the performance of services under Section 83 and, thus, are included in a participant's gross income as soon as the participant's interest in the assets is vested. However, this rule would not apply to assets located in a foreign jurisdiction if substantially all of the services related to the NQDC are performed in such foreign jurisdiction. The bill also contains a similar rule if NQDC assets become restricted to the payment of benefits upon a change in the employer's financial health.

For purposes of these proposals, a NQDC plan does not include a nonstatutory stock option ("NSO") plan under which options are granted at no less than the fair market value of the stock on the date of grant and under which there is no deferral feature other than the right to exercise the options in the future. A NQDC plan also does not include an ISO plan qualified under Section 422 or an ESPP qualified under Section 423. Presumably, the term does include NSOs granted at a discount or that provide a deferral feature. It also includes stock appreciation rights ("SARs"). Since SARs typically are exercisable at any time during a specified exercise period, the proposal could have a significant impact on the design of most SARs.

The proposal would be effective for amounts deferred in tax years beginning after December 31, 2004. Earnings on amounts deferred before the effective date would be subject to the proposal to the extent that such amounts deferred are subject to the proposal. Amounts deferred in tax years beginning before 2005 would be subject to the proposal only if the plan under which the deferral is made is materially modified after October 3, 2004. Operating under the terms of a plan that satisfies current law and that is not materially modified after October 3, 2004, with respect to amounts deferred before 2005, is permissible. Thus, redeferrals with respect to amounts deferred before 2005 under a plan that is not materially modified after October 3, 2004 would not be subject to the proposal.

For purposes of these grandfather provisions, a material modification is the addition of a benefit, right, or feature. For example, adding an early distribution provision or a provision accelerating vesting under a plan after October 3, 2004 would be a material modification that would trigger the application of the proposal to pre-2005 deferrals. In addition, an amount is considered deferred before 2005 only if it is both earned and vested before such date. Thus, nonvested benefits that were earned before 2005 *will* be subject to the proposal. Further, because the acceleration of vesting is a material modification that will cause the loss of the grandfather provision for all pre-2005 deferrals, employers do not have the ability to accelerate vesting of such nonvested benefits in order to pull them under the grandfather provision.

The IRS is directed to issue guidance within 60 days after the date of enactment for plans adopted by December 31, 2004 to provide a limited period in which the plans: (1) can be amended to permit termination of participation or cancellation of outstanding deferral elections, or (2) can be amended to conform to the proposal with respect to amounts deferred after 2004.

In the past, employers have had a great deal of flexibility in designing their NQDC plans. However, this proposal places significant restrictions on plan design. For example, many NQDC plans currently allow participants to change the time and form of benefit payments under the plan multiple times prior to when benefits first become payable under the plan. It is also common to allow acceleration of benefit payments on account of specified events or if a penalty (or "haircut") is imposed on early withdrawals. Yet to avoid current taxation under the proposal, a NQDC plan generally could not include, or would have to severely curtail, these types of provisions. Accordingly, as most employers will need to redesign their NQDC plans in light of this legislation, E&Y professionals should alert their clients immediately of these highly significant developments.

Deduction for personal use of company aircraft

The fair market value of an employee's personal use of an employer-provided aircraft is includible in income under Section 61 and Regulation Section 1.61-21(b). However, special valuation rules set forth in Regulation Section 1.61-21(g) (the so-called "SIFL rules") may be used to determine the fair market value of these personal flights. These SIFL rules generally produce taxable compensation that is significantly lower than the cost to the employer of the flight. Under Section 274(a), the cost of operating an aircraft used to provide personal travel is subject to disallowance as an entertainment facility cost. Section 274(e)(2) excepts from disallowance expenses for goods, services, and facilities "to the extent" treated as compensation and wages to employee recipients.

In *Sutherland Lumber-Southwest Inc. v. Commissioner* (114 T.C. 197 (2000), *aff'd* 255 F.3d 495 (8th Cir. 2001)), the IRS argued that the "to the extent" language of Section 274(e)(2) limited the employer's deduction to the amount treated as employee compensation---i.e., the amount determined using the SIFL rules---which was significantly less than the employer's cost of operating the aircraft. The employer, on the other hand, argued that the "to the extent" language allowed it to deduct its entire cost as long as the fair market value of the personal flights (as determined under the SIFL rules) was treated as compensation and wages. The Tax Court agreed with the employer, and the Eighth Circuit affirmed.

The proposal would overturn *Sutherland Lumber* and limit a company's deduction for certain executives' personal use of an employer-provided aircraft to the amount that is included in the executives' income (not the entire cost of operating the aircraft). The proposal would apply to individuals who, with respect to an employer or other service recipient, are subject to the requirements of section 16(a) of the Securities and Exchange Act of 1934, or would be subject to such requirements if the employer or service recipient were an issuer of equity securities referred to in section 16(a). Generally, these individuals are officers (as defined by section 16(a)), directors, and 10-percent-or-greater owners of private and publicly-held companies. Significantly, the provision applies to private companies (not just public companies as under the original proposal) and applies indefinitely (the original proposal would have expired January 1, 2006). The proposal would be effective for expenses incurred after the date of enactment.

The enactment of this provision will eliminate a significant portion of an employer's deduction with respect to its executives' personal use of an employer-provided aircraft. The provision is particularly significant for private companies, where use of the company plane by the top executives (who typically are shareholders) is often primarily personal.

Exclusion of ISOs and ESPP stock options (collectively, statutory options) from wages

In June 2002, the IRS announced that until further guidance is issued, it would not assess FICA or FUTA taxes, or impose federal income tax withholding obligations, upon either the exercise of a statutory option or the disposition of stock acquired pursuant to the exercise of a statutory option.

This proposal would put an end to the uncertainty surrounding this issue and provides that FICA and FUTA taxes do not apply upon the exercise of a statutory option. Also, such remuneration is not taken into account for purposes of determining Social Security benefits. Further, the proposal provides that no federal income tax withholding is required on a disqualifying disposition, or when compensation is recognized in connection with an ESPP

discount. The proposal would be effective for stock acquired pursuant to options exercised after the date of enactment.

Increase in withholding from supplemental wage payments in excess of \$1 million

In some cases under current law, supplemental wage payments (e.g., bonuses or commissions) may be subject to withholding at a flat rate based on the third lowest income tax rate (25% for 2005).

Under the proposal, once annual supplemental wage payments to an employee exceed \$1 million, any additional supplemental wage payments to the employee in that year would be subject to withholding at the highest income tax rate (35% for 2005). The proposal would be effective for payments made after December 31, 2004, and only applies for purposes of wage withholding.

Effective Date

The provision would be effective for tax years beginning after December 31, 2004.

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