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## Executive Compensation Techniques for Closely-Held Businesses

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**EXECUTIVE COMPENSATION TECHNIQUES**  
**FOR CLOSELY-HELD BUSINESSES**

By

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**EXECUTIVE COMPENSATION TECHNIQUES**  
**FOR CLOSELY-HELD BUSINESSES**

I. INTRODUCTION

Executive compensation planning for the closely-held business is primarily affected by tax considerations. The tax status of the employer, the intended tax treatment of the executive and the tax effects to the employer play a central role in selecting from among the various methods available for structuring executive compensation. In addition, the restrictions of Section 409A of the Internal Revenue Code introduce new design considerations.

This outline summarizes the most commonly used methods for structuring executive compensation for a closely-held business and the various tax considerations associated with each method. In addition, the outline addresses some of the special tax considerations associated with compensation arrangements involving S corporations, partnerships and LLCs.

There are other, non-tax considerations that should be kept in mind in designing executive compensation agreements for the closely-held business. For example, the Employee Retirement Income Security Act of 1974 (“ERISA”) may be applicable and thus may affect the manner in which an arrangement can be structured. The outline briefly addresses these ERISA considerations. In addition, federal and state securities laws frequently must be considered, particularly with respect to exemptions from registration for both equity-based compensation arrangements. Those securities law issues are beyond the scope of this outline.

II. INCENTIVE STOCK OPTIONS

A. Description

1. Incentive stock options (ISOs) are a form of tax-advantaged stock option. They may be granted only by corporate employers to their employees.
2. In order to provide employees with the tax advantages of ISOs, employers must comply with a number of conditions and limitations. Consequently, ISOs alone may not be capable of fully satisfying an employer’s executive

compensation objectives. ISOs are often utilized in conjunction with other forms of incentive compensation.

B. Tax Treatment

1. There are no income or alternative minimum tax consequences when an ISO is granted to an employee. See I.R.C. §§ 421(a), 56(b)(3) (tax event is the transfer of a share, not the transfer of the right to purchase a share).
2. As a general rule, the option holder does not recognize any income on exercise of the option or upon receipt of the underlying the shares, and the employer is not entitled to any deduction for transferring the shares, if both of the following requirements are met:
  - a. At all times during the period beginning with the date of option grant and ending three months before the date of exercise, the option holder was an employee of the employer or of a parent or subsidiary of the employer (except in the case of option holder's disability, in which case the period is extended to 1 year before the date of exercise), and
  - b. The option holder makes no disposition of the stock during two years from the date of option grant or during one year from the date of option exercise. See I.R.C. §§ 421(a), 422(a).
3. If these conditions are met, the option holder will have a basis in the shares equal to the exercise price, and any gains recognized on disposition of the shares will be taxed at long-term capital gains rates. See I.R.C. §§ 421(a)(3), 1222(3)
4. If the option holder does not meet the employment condition described in subsection (2)(a) above, the option will be treated as a nonstatutory stock option, and the option holder will recognize ordinary income at the time of option exercise on the amount by which the FMV of the stock exceeds the option exercise price. The employer is entitled to a deduction of an equivalent amount in the year of exercise. See I.R.C. § 83 (discussed in greater detail below).
5. If the option holder does not meet the disposition condition described in subsection (2)(b) above, the holder will recognize ordinary income equal to the lesser of:
  - a. The option spread at the time of exercise (i.e., difference between FMV of stock and exercise price), or
  - b. The excess of the amount realized upon disposition of the option and the option exercise price

The employer is entitled to a corresponding deduction in the same taxable year. See I.R.C. § 421(b).

6. The spread between the fair market value (“FMV”) of the stock and the option exercise price is alternative minimum taxable income to the ISO holder in the year the ISO is exercised. See I.R.C. §§ 55, 56(b)(3).
7. Employers are not required to withhold FICA or FUTA taxes on the option spread at the time the ISO is exercised. Likewise, no FICA, FUTA or income tax withholding is required for any income recognized as a result of disposition of shares before the end of the holding periods described in subsection (b)(2) above. See I.R.C. §§ 3121(a)(22), 3306(b)(19), 421(b).

#### C. ISO Qualification Requirements

1. ISOs may only be granted by corporations to their employees or the employees of affiliated corporations. At all times during the period beginning on the date of grant to three months before exercise, the option holder must be an employee of the corporation that granted the option or an employee of a “parent” or “subsidiary” of the granting corporation. A parent or subsidiary relationship exists if there is an unbroken chain of ownership of at least 50% of the voting power at each corporate level. See I.R.C. §§ 422(a)(2), 424(e), 424(f).
2. ISOs may only be granted with respect to stock of a corporation. Any type of stock will qualify (voting, nonvoting, common, preferred, etc.). See Treas. Reg. § 1.421-1(d).
3. ISOs must be granted under a written or electronic plan that was approved within 12 months before or after the plan was adopted by the corporation’s board of directors. A change in the class of eligible employees, the number of shares reserved for issuance, the corporation granting options or the stock available for ISOs is treated as the adoption of a new plan which requires new shareholder approval. See Treas. Reg. § 1.422-2(b)(1), (2).
4. The written plan must (1) state the employees or class of employees who are eligible to receive ISOs, and (2) state the aggregate number of shares that may be issued as ISOs under the plan. Provisions for periodic increases in the number of shares authorized for issuance under the plan are permitted under certain limited circumstances. See Treas. Reg. § 1.422-2(b)(4), (3).
5. Neither the option plan nor the ISOs granted under it may have a term of more than ten years. In determining whether the plan meets this rule, the term is measured from the earlier of the date the plan was adopted or the

date on which the plan was approved by shareholders. See I.R.C. § 422(b)(2), (3).

6. The ISO exercise price can be no less than the FMV of the stock on the date the ISO is granted. The employer may use “any reasonable valuation method” for determining the exercise price. Even if this requirement is not met, the option will qualify as an ISO if, under the facts and circumstances, there was a good faith attempt to set the option exercise price at no less than the FMV of the stock on the date of option grant. For a private company, a good faith attempt is deemed to have been made if the price was determined based on the average of appraisals by “completely independent and well-qualified experts.” See Treas. Reg. §§ 1.421-1(e), 1.422-2(e).
7. The ISO must state that it cannot be transferred, except by will or by descent and distribution. In addition, the ISO cannot be exercised during the optionee’s lifetime by anyone other than the optionee (or his representative in the event of his death). See I.R.C. § 422(b)(5); Treas. Reg. § 1.421-1(b)(2). Under this rule, a transfer of an ISO to a grantor trust established by the option holder does not disqualify the ISO. However, a transfer incident to divorce or a domestic relations order would disqualify the ISO.
8. No more than \$100,000 worth of shares under the option may first become exercisable in any one year. The limit is determined at the time of grant, is based on the FMV of the shares at the time of grant and is determined without regard to how many shares the employee actually exercises. See I.R.C. § 422(d); Treas. Reg. § 1.422-4.
  - a. For example, assume an employer wants to grant to an employee 60,000 shares under an ISO when the shares are worth \$2 per share. A maximum of 50,000 shares can become exercisable in the year the ISO is granted ( $50,000 \times \$2 = \$100,000$ ). The remaining 10,000 shares can become exercisable in the second year ( $10,000 \times \$2 = \$20,000$ ).
  - b. All of the ISOs held by an employee are taken into account in applying the limit. The limit is applied by taking options into account in the order in which they were granted.
9. Special limitations apply to ISOs that are granted to persons who own more than 10% of the total combined voting power of all classes of stock of the employer corporation or any parent or subsidiary corporation (a “10% shareholder”). The option term can be no longer than five years and the option exercise price must be at least 110% of the FMV of the underlying shares at the time of grant. See I.R.C. § 422(c)(5); Treas. Reg. § 1.422-2(f).



10. A modification, extension or renewal of the terms of an ISO is considered the granting of a new option. As a result, the modification, extension or renewal can cause the option to lose ISO status if the option cannot meet all of the ISO requirements as of the date of modification, extension or renewal (such as the exercise price requirement). See I.R.C. § 424(h)(1); Treas. Reg. § 1.424-1(e). There are a number of rules for determining which changes to an ISO constitute a “modification.” See Treas. Reg. § 1.424-1(e)(4)(i), et seq.
11. ISO option agreements and ISO plans are not required to specify the three month exercise condition described above. An ISO that by its terms permits exercise beyond the three-month period following termination of employment will continue to qualify for ISO treatment if it meets the other requirements applicable to ISOs and the option holder exercises the option within that period. See Treas. Reg. § 14a.422A-1, Q&A 23 (transition rules which predate final regulations). If the option is exercised after the end of the three-month period, the option is treated as a nonstatutory stock option and is taxed under the rules applicable to such options. See Treas. Reg. § 1.422-1(c).

D. Applicability of Section 409A

1. ISOs are generally exempt from Section 409A. See Prop. Treas. Reg. § 1.409A-1(b)(5)(ii).
2. Even if an ISO fails to meet the ISO qualification requirements in a way that causes the option to be treated as a nonstatutory stock option, the option may still qualify for exemption from Section 409A (see discussion at Section III.C below). Similarly, a modification, extension or renewal of an ISO generally causes the ISO to be treated as a nonstatutory stock option, requiring analysis of whether the modified, extended or renewed option can continue to qualify for exemption from Section 409A. See Prop. Treas. Reg. § 1.409A-1(b)(5)(ii).

- E. ERISA Considerations. Stock option plans and the options granted under them generally do not constitute employee benefit plans subject to the Employee Retirement Income Security Act of 1974 (“ERISA”). See, e.g., Department of Labor ERISA Adv. Op. 79-80A; Oatway v. American International Group, Inc., 325 F.3d 184 (3<sup>rd</sup> Cir. 2003).

III. NONSTATUTORY OPTIONS ON STOCK OR OTHER EMPLOYER PROPERTY

A. Description

1. A nonstatutory option (NSO) is an option to acquire property that does not meet the requirements described above for ISOs. See Treas. Reg. § 1.83-7(a).

2. Although NSOs do not provide option holders with the same tax advantages of ISOs, they are not subject to the ISO qualification requirements and thus provide a greater degree of design flexibility. Furthermore, NSOs provide employers with a deduction, while ISOs provide a deduction only if there is a disqualifying disposition of the underlying stock. Finally, NSOs can relate to stock of a corporation or certain other forms of employer equity (although Section 409A imposes some restrictions in this regard).

B. Tax Treatment

1. The tax treatment of an NSO is governed by Section 83 if the NSO was granted to an employee or another service provider in connection with the performance of services. See Treas. Reg. § 1.83-7(a); T.A.M. 200043013 (warrants given by bankrupt company to bank creditor are not taxable under the rules of Section 83, and therefore do not give rise to a compensation deduction, because they were not granted in connection with the bank's performance of services to the company).
2. There are no income tax consequences at the time of grant unless the NSO has a "readily ascertainable fair market value." In order for an NSO to have a readily ascertainable FMV, the NSO must either be traded on an established market (which is rarely, if ever, the case), or each of the following factors must exist:
  - a. the option is transferable,
  - b. the option is immediately exercisable in full,
  - c. there are no conditions or restrictions on the option property which affect the FMV of the option, and
  - d. the option privilege can be valued with reasonable accuracy.

See Treas. Reg. § 1.83-7(b)(1), (2).

3. At the time an NSO is exercised, the optionee recognizes ordinary income on the amount by which the FMV of the underlying shares at the time of exercise exceeds the amount paid by the optionee to exercise the option. However, if the shares are subject to a substantial risk of forfeiture when issued, the taxable spread is not determined until the risk of forfeiture lapses. The spread is considered wages for purposes of FICA and FUTA withholding. There are no alternative minimum tax consequences with respect to the exercise of a NSO. See I.R.C. § 83(a); Treas. Reg. § 1.83-7(a).
4. The recipient of the option holder's services is allowed a deduction equal to the amount included in the optionholder's taxable income. See I.R.C. §

83(h), Treas. Reg. § 1.83-6; see also Rev. Rul. 2003-98 (corporation that was the recipient of the services performed by the option holder is entitled to a deduction in connection with optionholder's exercise of a replacement option granted by acquirer).

5. The option holder's basis in the shares acquired under an NSO is generally equal to the exercise price of the NSO, and the holding period generally runs from the date of exercise. See Treas. Reg. § 1.83-4.

#### C. Applicability of Section 409A

1. An NSO that entitles a service provider to acquire "service recipient stock" is exempt from Section 409A if (1) the option exercise price may never be less than the fair market value of the underlying shares on the date of grant, (2) the number of shares subject to the option are fixed on the date of grant, (3) the transfer or exercise of the option is subject to taxation under Section 83 and (4) the option has no feature allowing for the deferral of recognition of income beyond the date of exercise or the date the stock becomes substantially vested. See Prop. Treas. Reg. § 1.409-1(b)(5)(i)(A).
  - a. Service recipient stock is defined as common stock of the service recipient or a member of its controlled group. Controlled group status is generally determined under Section 414(b) and (c), although the 80% common ownership threshold is reduced to 50%, and can be reduced to 20% under certain circumstances. Only the corporation's common stock that has the greatest aggregate value, or stock with rights substantially similar to such common stock, can qualify as service recipient stock. Special rules allow for voting rights to be disregarded in performing this analysis, but in no event may stock with a dividend or liquidation preference be treated as service recipient stock. See Prop. Treas. Reg. § 1.409A-1(b)(5)(iii).
  - b. Section 409A provides a facts and circumstances test for determining whether privately-held stock has been accurately valued. Accurate valuation is necessary to comply with the exercise price requirement of the stock option exemption. The test requires a reasonable application of a reasonable valuation method. A rebuttable presumption of reasonableness can be established under one of three separate safe harbor valuation methods, but the safe harbors are limited in a number of respects. See Prop. Treas. Reg. § 1.409A-1(b)(5)(iv). In addition, special transition rules permit options granted before January 1, 2005 to be deemed to meet these requirements if the underlying shares were valued under the ISO "good faith attempt" standard. In addition, options granted on or after January 1, 2005, but before final Section 409A

regulations take effect, may be valued under any reasonable valuation method. See Notice 2006-4, 2006-3 I.R.B. 307, (December 23, 2005).

2. An option may become subject to Section 409A if the option is extended, renewed or modified in certain respects. For example, extending the option's originally specified termination date beyond a certain safe harbor period constitutes an extension, the result of which is that the option is treated as having had an impermissible deferral feature since the date on which it was originally granted. See Prop. Treas. Reg. § 1.409A-1(b)(5)(v).
3. An NSO to acquire property other than service recipient stock generally will be subject to Section 409A. Since the option exercise right generally cannot comply with the fixed payment event requirements of Section 409A (as well as the anti-acceleration prohibition and subsequent deferral restrictions), options on property other than service recipient stock will generally give rise to taxable income (as well as a 20% penalty) in the first taxable year the NSO is exercisable and in-the-money. A notable exception is for NSOs on partnership (and LLC) interests. Until further guidance is issued, options on such interests generally are treated as subject to rules similar to those applicable to service recipient stock. See Notice 2005-1, Q&A-7, 2005-2 I.R.B. 274 (December 20, 2004).

D. ERISA Considerations. As described in Section II.A.4 above, stock option plans and the options granted under the plan generally are not considered to be subject to ERISA.

#### IV. RESTRICTED STOCK

##### A. Description

1. The term "restricted stock" broadly refers to shares that are granted outright or sold for consideration to an employee or other service provider. The stock is generally not transferable and is subject to forfeiture if certain conditions are not met (generally continued service with the employer over a designated future period). The award can also be structured as a "restricted stock unit" under which the employee receives a certain number of hypothetical units which are settled in either unrestricted or restricted shares if certain conditions are met (see also the discussion at Section VI).
2. Other types of employer property, such as partnership and LLC interests, can be awarded in a fashion similar to restricted stock. A discussion of such awards is contained in Section IX below.

B. Tax Treatment

1. There are no income tax consequences to the recipient of the stock at the time of receipt, so long as the stock is “substantially nonvested.” Stock is substantially nonvested so long as it is (1) nontransferable, and (2) subject to a substantial risk of forfeiture. The employee (or other service provider) is taxed on the FMV of the restricted stock in the first taxable year in which the stock becomes transferable or is no longer subject to a substantial risk of forfeiture. Only one of these restrictions needs to lapse in order to cause the stock to become taxable. See I.R.C. § 83(a); Treas. Reg. § 1.83-3(b).
2. Stock is considered nontransferable if the holder cannot transfer any interest in the stock other than back to the transferor. Stock is not considered transferable merely because the holder can designate a beneficiary to receive the stock in the event of his or her death. See Treas. Reg. § 1.83-3(d).
3. A “substantial risk of forfeiture” exists where the holder’s rights in the stock are conditioned, directly or indirectly, on either:
  - a. the performance of future substantial services (or refraining from the performance of such services), or
  - b. the occurrence of a condition related to the purpose of the transfer, and the possibility of forfeiture is substantial if the condition is not satisfied.

The determination of whether a risk of forfeiture is substantial is dependent upon the individual facts and circumstances surrounding the transfer. See Treas. Reg. § 1.83-3(c).

4. The employer is entitled to a compensation deduction equal to the amount of income recognized by the employee in connection with the award. The deduction is allowed in the same taxable year in which the holder of the stock recognized the income, or the taxable year in which ends the holder’s taxable year. See I.R.C. § 83(h).
5. However, the deduction may be lost if the employer does not properly report the income recognized by the holder on Form W-2 or Form 1099, as applicable. See Treas. Reg. § 1.83-6(a)(1), (2).

C. The Section 83(b) Election

1. If restricted stock is nontransferable and subject to a substantial risk of forfeiture when transferred, the recipient of the restricted stock may make an election to be taxed on the FMV of the stock at the time of transfer. See I.R.C. § 83(b).

2. The advantage of making a Section 83(b) election is that the compensation element of the award is closed on the date of transfer, thereby subjecting subsequent appreciation to capital gains tax rates at the time the stock or other property is sold. In addition, the election starts the recipient's holding period. See I.R.C. § 1.83-4(a).
3. The disadvantage of the election is that the recipient may end up paying more ordinary income than he would otherwise have paid if the shares decrease in value over the restriction period. In addition, the recipient is not entitled to any loss deduction for the taxes paid at the time of the election if the recipient ultimately forfeits the shares. See Treas. Reg. § 1.83-2(a).
4. A Section 83(b) election is subject to a number of requirements. The election must be made within 30 days of transfer of the restricted stock, and must contain certain information concerning the transfer and the underlying stock. The election is filed with the IRS office where the recipient files his income tax return. Additional copies of the election must be provided to the transferor of the restricted stock and filed with the recipient's income tax return for the taxable year of the transfer. The election cannot be revoked unless consented to by the IRS. See Treas. Reg. § 1.83-2.
5. Section 83(b) elections can even be made in circumstances in which the recipient has paid an amount equal to fair market value for the stock. This may be desirable where the transferor has a right to repurchase the shares for a period of time at a price equal to the recipient's original purchase price or some formula price. Such a call right will generally be treated as creating a substantial risk of forfeiture. See Treas. Reg. § 1.83-3(c)(4), Example 1.
6. The employer is entitled to a compensation deduction in the taxable year in which the recipient recognizes income as a result of the election, equal to the amount of income recognized by the recipient. See I.R.C. § 83(h).

D. Applicability of Section 409A

1. A grant of restricted stock (or other employer property) is generally not subject to Section 409A. See Prop. Treas. Reg. § 1.409A-1(b)(6).
2. However, a promise to deliver restricted stock in a future taxable year is not automatically exempt from Section 409A, such as a restricted stock unit. See Prop. Treas. Reg. § 1.409A-1(b)(6)(ii). Such a promise may nevertheless qualify for exemption from Section 409A if the shares are required to be delivered to the employee within two and one-half months following the end of the taxable year in which the shares cease to be subject to a substantial risk of forfeiture (i.e., a "short-term deferral"). See

Prop. Treas. Reg. § 1.409A-1(b)(4). See Section VI.C for further discussion of the short-term deferral exception.

- E. ERISA Considerations. Restricted stock awards are generally not considered to be employee benefit plans subject to ERISA. However, if awards are structured so as to permit shares to continue to vest following termination of employment, the arrangement could constitute an ERISA pension plan. See Department of Labor ERISA Adv. Op. 80-29A.

## V. STOCK APPRECIATION RIGHTS

### A. Description

1. A stock appreciation right (SAR) gives the holder the right to receive a benefit equal to the appreciation in value of the employer's stock over a period of time. SARs can be settled in cash, stock or a combination of the two. Appreciation rights can also be granted with respect to partnership or LLC interests, as described in Sections VIII and IX below.
2. SARs are similar to stock options in that the holder determines when he or she will exercise the SAR and no tax is generally incurred until that time. At exercise, the holder receives the difference between the value of the shares on the date of exercise and the exercise price, without having to actually pay the exercise price. SARs can be granted in tandem with stock options. A common reason for using tandem SARs is to provide the employee with funds to pay taxes on the exercise of a NSO. There are restrictions on the use of tandem SARs in connection with ISOs. See Treas. Reg. § 1.422-5(d)(3).

### B. Tax Treatment

1. There is no tax at the time the SAR is granted. The holder is taxed at ordinary income rates on any amounts actually or constructively received when the SAR is exercised. See Rev. Rul. 80-300, 1980-2 C.B. 165; Rev. Rul. 82-121, 1982-1 C. B. 79. The amount received under the SAR is also subject to FICA and FUTA tax at the time of exercise. See Treas. Reg. § 31.3121(v)(2)-1(b)(4)(ii) (SARs are not subject to the special early inclusion rule applicable to nonqualified deferred compensation plans, thus FICA tax is payable only when the SAR is exercised).
2. The employer is permitted a compensation deduction equal to the income recognized by the holder of the SAR at the time of exercise. See I.R.C. § 162(a)(1).

C. Applicability of Section 409A

1. SARs are exempt from Section 409A if they meet conditions similar to those described in Section III.C below for NSOs on service recipient stock. See Prop. Treas. Reg. § 1.409A-1(b)(5)(i)(B).
2. Pending issuance of further guidance, appreciation rights granted with respect to partnership or LLC interests are also eligible for exemption from Section 409A if they generally satisfy the same conditions as are applicable to SARs under Section 409A. See Notice 2005-1, Q&A-7.

D. ERISA Considerations. SARs are generally not considered to be ERISA employee benefit plans. However, SARs that provide for settlement solely and automatically upon termination of the holder's employment or retirement may constitute ERISA pension plans. See ERISA § 3(2).

VI. PHANTOM STOCK PLANS

A. Description

1. Phantom stock are hypothetical units that are assigned a value equal to the value of the employer's stock at the time of award. The units provide the holder with the right to receive the original value of the unit and any subsequent appreciation in value if certain conditions are met, such as the holder's completion of a specified period of future service with the employer. Alternatively, a phantom stock plan can be structured to provide a benefit based only on the appreciation in the assigned value of the units over time, instead of on the total assigned value of the unit.
2. Payment of benefits under a phantom stock plan can be structured in a variety of ways. For example, payment can be made in a single lump sum immediately following completion of a vesting schedule. Alternatively, payment can be delayed to termination of employment or some later specified date (such as attainment of retirement age or the occurrence of a liquidation event), and settlement can be made through installment payments instead of a lump sum payment.

B. Tax Treatment

1. If the date for any payment of benefits under the plan is fixed at the time the employee receives the phantom stock units the employee will recognize ordinary income at the time payment is actually received. Income will be based on the amount of cash or the FMV of the property received by the employee. See I.R.C. § 451; Treas. Reg. § 1.451-2(a); P.L.R. 9501032.
2. As noted below, phantom stock arrangements are generally subject to Section 409A, thus requiring that payment be made only upon the



occurrence of certain specified events or at a fixed time. See I.R.C. § 409A(a)(2).

3. FICA and FUTA taxes must generally be withheld at the later of when the phantom units are awarded to the employee or when the employee has a vested right to receive a benefit with respect to the units. See I.R.C. § 3121(v); Treas. Reg. 31.3121(v)(2)-1(b)(4)(ii).

C. Applicability of Section 409A

1. Phantom stock arrangements will generally constitute “nonqualified deferred compensation plans” subject to Section 409A. Consequently, they must be structured to comply with the requirements of Section 409A (see Section VII.C below).
2. However, a phantom stock plan can be designed to be exempt from Section 409A if the plan qualifies for the short-term deferral exception. A short-term deferral is an arrangement under which the compensation is paid to the employee within no later than 2 and 1/2 months following the end of the year in which the employee becomes vested in the right to receive the compensation (i.e., the year in which the employee’s rights cease to be subject to a substantial risk of forfeiture). The year of vesting on which the 2 and 1/2 month deadline is based is either the employer’s or the employee’s tax year, whichever ends later. The 2 and 1/2 month deadline can be extended under certain circumstances. See Prop. Treas. Reg. § 1.409A-1(b)(4).

- D. ERISA Considerations. Phantom stock plans may be ERISA pension plans if benefits are payable at termination of employment or retirement, or if benefits are deferred to a date at which employees can generally be expected to retire or terminate employment. See Department of Labor ERISA Adv. Op. 79-60A. For this reason, phantom stock plans are often designed to pay benefits at the end of specified measurement periods, without any acceleration or deferral of payment on account of early or late retirement. See Department of Labor ERISA Adv. Op. 84-12A. Alternatively, phantom stock plans that are structured to pay benefits at termination of employment generally limit participation to only a select group of executive employees so that the plan may qualify as a “top-hat” plan and thus qualify for exemption from most of ERISA’s substantive requirements. See discussion in Section VII.F below.

## VII. DEFERRED COMPENSATION ARRANGEMENTS

A. Description

1. The traditional method to compensate employees is with cash. Deferred payment of cash is frequently used to retain executive talent or as an incentive for attainment of specific performance objectives. In addition, deferred compensation is used to provide supplemental retirement income.

2. Deferred payment of cash raises a number of tax and ERISA considerations that must be taken into account in designing and implementing a deferred compensation plan. Section 409A significantly restricts some of the design flexibility previously inherent in deferral compensation.

B. Tax Treatment

1. Amounts payable under a deferred compensation plan are taxed at ordinary income rates. The benefits are generally taxed only at the time of actual receipt, unless the recipient is deemed to be in constructive receipt of the benefits. See Treas. Reg. § 1.446-1(c)(1)(i). As noted above, Section 409A now imposes a new set of requirements regarding the form and operation of such plans. The IRS takes the position that Section 409A merely supplements (and does not supplant) the general principles of constructive receipt applicable to nonqualified deferred compensation plans.
2. The question of whether and when an employee is in constructive receipt of deferred compensation benefits is not always clear. The IRS has traditionally taken a very conservative approach. Under a long line of rulings, the IRS takes the position that an employee is not in constructive receipt of deferred compensation so long as:
  - a. The employer's obligation to pay the deferred compensation is merely a contractual obligation not evidenced by notes or secured in any way against the claims of the employer's general creditors
  - b. The deferral agreement or plan was entered into before the executive performs the services to which the compensation relates
  - c. The deferral agreement or plan specifies the time when or circumstances under which the deferred compensation will be paid.

See Rev. Rul. 60-31, 1960-1 C.B. 174; Rev. Proc. 71-19, 1971-1 C.B. 698, as amplified by Rev. Proc. 92-65, 1992-33 C.B. 428. Although the 1971 and 1992 revenue procedures are only a statement of the criteria that a plan must meet in order for the IRS to issue a private letter ruling, they have traditionally been viewed as representing the IRS's general position on the application of the constructive receipt and economic benefit doctrines to non-qualified deferred compensation plans.

3. The courts typically have not applied as strict an interpretation of constructive receipt as has the IRS. See, e.g., Veit v. Commissioner, 8 T.C. 809 (1947); Commissioner v. Oates, 207 F.2d 711 (7<sup>th</sup> Cir. 1953), aff'd 18 T.C. 570 (1952) Martin v. Commissioner, 96 T.C. 814 (1991); Childs v. Commissioner, 103 T.C. 634 (1994). As a result, deferred

compensation plans are generally not designed to satisfy all of the conditions contained in the revenue procedures described above.

4. Although deferred compensation generally is not subject to income tax until received, it is subject to FICA and FUTA taxes at the later of (1) when the compensation is earned or (2) when the compensation is no longer subject to a substantial risk of forfeiture. See I.R.C. § 3121(v)(2); Treas. Reg. § 31.3121(v)(2)-(1).

#### C. Applicability of Section 409A

1. Section 409A applies to all “nonqualified deferred compensation plans,” a term which is broadly defined to mean any plan that provides the employee or other service recipient with a legally binding right to compensation that is payable in a later taxable year. See I.R.C. § 409A(d). In addition to the exceptions described earlier in this outline, there are exceptions for (1) qualified retirement plans and certain other tax-advantaged savings and retirement vehicles, and (2) plans providing vacation leave, sick time, compensatory time, disability pay, death benefits and certain other welfare benefits.
2. Section 409A imposes specific conditions that an arrangement must satisfy to avoid current taxation of compensation deferred under the plan, as well as the imposition of a 20% penalty and interest for late payment of taxes. The restrictions are in three primary areas:
  - a. Restrictions on the timing of initial and subsequent deferral elections.
  - b. Specification of the times or events upon which distributions may be made.
  - c. General prohibition on accelerated payment of previously deferred amounts.
3. Plans and other arrangements subject to Section 409A must be in writing and must reflect a number of the substantive requirements of the statute and regulations in their terms. See Prop. Treas. Reg. § 1.409A-1(c)(3).

#### D. ERISA Considerations

1. Deferred compensation plans typically are ERISA pension plans because compensation is paid upon termination of employment or retirement, or is deferred beyond those dates. See ERISA § 3(2).
2. In order to effectively defer the taxation of benefits under a nonqualified deferred compensation plan, the plan generally must qualify as a “top-hat” plan. Top hat plans are exempt from all of ERISA’s substantive

requirements, except for certain reporting requirements and ERISA's enforcement provisions. See ERISA §§ 201(2), 301(a)(3), 401(a)(1).

3. A deferred compensation plan will qualify as a top-hat plan if the plan is unfunded, and is maintained to provide deferred compensation to a "select group of management or highly compensated employees."
  - a. A plan will generally be considered to be unfunded so long as plan participants and their beneficiaries do not have any secured claim against any assets of the employer, and the employer has not set aside from the reach of creditors assets to fund the deferred compensation promise. See Belka v. Rowe Furniture Corp., 571 F. Supp. 1249 (D. Md. 1983).
  - b. The Department of Labor has never adopted final guidance providing standards for determining a select group of management or highly compensated employees. The courts have recognized that the determination is fact-sensitive, and generally have refrained from adopting definitive standards for making this determination. See, e.g., Demery v. Extebank Deferred Compensation Plan (B), 216 F.3d 283 (2<sup>nd</sup> Cir. 2000); Gallione V. Flaherty, 70 F.3d 724 (2<sup>nd</sup> Cr. 1995); Simpson v. Ernst & Young, 879 F. Supp. 802 (S.D. Ohio 1994).

## VIII. SPECIAL CONSIDERATIONS FOR S CORPORATIONS

### A. Compliance with Qualifying Shareholder Limitations

1. S corporations can have no more than 100 shareholders. None of those shareholders can be nonresident aliens. An election may be made to treat all family members as a single shareholder. See I.R.C. § 1361(b)(1)(A), (C). Violation of these limitations will generally cause a loss of S corporation status.
2. Options on or outright awards of S corporation stock must be carefully monitored to avoid violating these limits. In accordance with general tax principles, holders of stock options generally are not considered to hold the stock underlying the option until the option is exercised.
3. Holders of restricted S corporation stock are not considered to be shareholders for as long as the stock is substantially nonvested (i.e., subject to a substantial risk of forfeiture and nontransferable). However, if the holder makes an 83(b) election the stock is treated as outstanding and the holder will be considered a shareholder or the S corporation. See Treas. Reg. § 1.1361-1(b)(3); see also PLR 200510011 (distributions to holders of restricted stock for which no Section 83(b) elections were made potentially terminated the S corporation election).

- a. Consequently, an employer needs to carefully monitor whether an 83(b) election has been made to determine whether the shares should be treated as outstanding and thus entitled to distributions. Employers that do not wish to make distributions while shares continue to be subject to a vesting condition frequently require as a condition of the award that the employee agree not to make a Section 83(b) election.
- b. It is interesting to note that a grant of restricted profit interests in a LLC or partnership must provide for distributions even while the interest is unvested. See Rev. Proc. 2001-43, 2001-2 C.8. 191 (discussed in further detail at Section IX.B.4 below).

**B. Second Class of Stock Concerns**

1. S corporations may not have more than one class of stock. See I.R.C. § 1361(b)(1)(D).
2. Stock options issued to employees or independent contractors in connection with the performance of services for the S corporation or for a more than 50% owned subsidiary corporation of the S corporation will not be considered to create a second class of stock if the following conditions are met:
  - a. The compensation provided by the option is not excessive in relationship to the services performed,
  - b. The option is not transferable by the optionee (as determined under the regulations of I.R.C. § 83), and
  - c. The option does not have a readily ascertainable fair market value (as determined under the regulations under I.R.C. § 83).

See Treas. Reg. § 1.1361-1(l)(4)(iii)(B)(2).
3. Phantom stock arrangements, SARs and deferred compensation plans generally do not create a second class of stock if they do not confer any voting rights to employees, merely represent an unfunded promise to pay an amount in the future, are issued to an employee or independent contractor in connection with the performance of services, and are issued under a plan pursuant to which the employee or independent contractor is not currently taxed. See Treas. Reg. § 1.1361-1(b)(4); P.L.R. 9840035; P.L.R. 9040035.
4. Restricted stock will not be a second class of stock so long as it is substantially nonvested. Shares that have become vested or for which an employee has made a Section 83(b) election will not create a second class of stock so long as the stock provides distribution rights and liquidation

rights that are identical to those of other shares. Differences in voting rights are generally disregarded. See Treas. Reg. § 1.1361-1(l)(1), (3). Similarly, a plan which provided for bonuses to enable employees to exercise options to acquire employer stock did not create a second class of stock. See PLR 200537010.

## IX. SPECIAL CONSIDERATIONS FOR PARTNERSHIPS AND LLCs

### A. ISOs Not Available

1. ISOs may only be granted with respect to the stock a corporation. See Treas. Reg. § 1.421-1(a)(1). Therefore, options to acquire LLC or partnership interests cannot qualify for ISO treatment, except in the case of an LLC that has elected to be taxed as a corporation. See Treas. Reg. §§ 1.421-1(i)(1), 301.7701-3(a).
2. By contrast, S corporations are treated as corporate entities and options on S corporation stock can qualify for ISO treatment. See Treas. Reg. § 1.421-1(i)(1); P.L.R. 9840035.

### B. Transfers of Partnership/Membership Interests – Current Law

1. Except as described above, partnerships and LLCs generally may grant all of the same types of equity-based compensation awards that corporate employers may award (all following references to “partnerships” are intended to include LLCs taxes as partnerships). The tax treatment of these awards generally has been dependant upon whether the underlying equity interest is a capital interest (a right to receive a share of the business’s assets upon liquidation) or a profits interest (a right only to a share of the profits of the business). As discussed in greater detail below, proposed regulations would apply Section 83 to any transfer of partnership interests in consideration of the performance of services, without regard to whether the interests are capital interests or profits interests.
2. Transfer of a capital interest in exchange for services is generally not considered eligible for non-recognition treatment. See I.R.C. § 721; Treas. Reg. § 1.721-1(b)(1). The amount and timing of tax recognition is determined under the rules of Sections 61 and 83.
  - a. Unrestricted Interests. The fair market value of an unrestricted capital interest (i.e. one that is fully vested at the time of transfer) is ordinary income to the recipient on the date of transfer, less the amount (if any) that the recipient paid for the interest. See Treas. Reg. § 1.721-1(b)(1). The partnership will be able to deduct or amortize the amount the recipient reports in income. See I.R.C. § 83(h), 162 and 212.

- b. Restricted Interests. If the interest is subject to a substantial risk of forfeiture at the time of transfer, the fair market value of the capital interest (less the amount paid by the transferee, if any) will be ordinary income to the transferee when the risk of forfeiture lapses. The partnership will be able to deduct or amortize the payment at the time the recipient reports the income. In addition, the recipient may elect to make an election to be taxed on the fair market value of the interest as of the date of transfer. See I.R.C. § 83(b). The recipient will immediately become a member if the 83(b) election is made. See Treas. Reg. 1.83-2(a).
3. A transfer of profits interests to a service provider in exchange for services to the partnership is not a taxable event for either the recipient of the interests or for the existing partners if:
- a. The recipient is already acting in a partner capacity or the award is in anticipation of the recipient acting in a partner capacity,
  - b. The interest does not relate to a “substantially certain and predictable stream of income,”
  - c. The partner holds the interest for at least two years after receipt, and
  - d. The partnership is not publicly traded.

See Rev. Proc. 93-27, 1993-2 C.B. 343.

4. The IRS subsequently clarified this position in response to concerns with respect to restricted profits interests (i.e., those subject to vesting conditions). An unvested interest is considered to have been transferred to the recipient on the date of grant if all of the conditions of Revenue Procedure 93-27 are met and:
- a. the recipient of the profits interest is treated as the owner of the interest from the date of grant and the recipient takes into account the distributive share of tax items associated with the interest for the entire period that the recipient holds the interest, and
  - b. neither the partnership nor any of the partners deduct any amount for the fair market value of the profits interest when the interest is granted or when it becomes vested.

See Rev. Proc. 2001-43, 2001-2 C.B. 191. As noted above, this should be contrasted with the treatment of a transfer of S corporation restricted stock for which no Section 83(b) election is made.

5. These IRS positions create an attractive planning opportunity that cannot be replicated under any of the equity-based incentive compensation arrangements available to corporate employers. However, certain issues should be considered before granting employees profits interests:
  - a. If the partnership attaches a vesting schedule to the award, recipients may still wish to make protective Section 83(b) elections.
  - b. Because the special rule only applies to persons who are partners or who are expected to become partners, grants to non-partner employees may not qualify for the rule unless the employee will have some attributes of a partner. Consequently, careful consideration should be given the employee's management rights and other indicia of partner status. See P.L.R. 9533008.
  - c. The holder of the interest would be entitled to distributions for the entire period he holds the interest, even if the interest is subject to vesting conditions.

C. Proposed Law Changes

1. In 2005, the IRS proposed a comprehensive new set of rules concerning partnership interests transferred in connection with performance of services. The new rules would treat any transfer of a partnership interest in exchange for services (whether a capital interest or a profit interest) as a transfer of property subject to Section 83. While the new rules essentially confirm the tax treatment of capital interest transfers, they substantially change existing rules applicable to transfers of profit interests. Nevertheless, the new rules would continue to allow profits interest transfers to qualify for tax treatment similar to that afforded under current law, but impose some important new requirements to obtain such tax treatment. See Proposed Regulations on Partnership Equity for Services, 70 Fed. Reg. 29675 (May 24, 2005); Notice 2005-43, 2005-24 I.R.B. 1221 (May 20, 2005) (containing a proposed revenue procedure). The new rules will not take effect until final regulations are issued.
2. As explained earlier in this outline (see Section IV. B), Section 83 requires a service provider to report as ordinary income the value of property received for the performance of services, minus any amount the service provider pays for such property. This tax recognition is delayed if the property is subject to restrictions, unless the service recipient makes an 83(b) election. By imposing this regime on profit interests, the proposed regulations would impose a valuation requirement that is largely absent under the current rules. Valuation of profits interests has traditionally been a contentious proposition. See Campbell v. Commissioner, 943 F.2d



815 (8th Cir. 1991); Diamond v. Commissioner, 56 T.C. 530 (1971), aff'd, 492 F.2d 286 (7th Cir. 1974).

3. This valuation concern is somewhat softened under the proposed regulations by the availability of a safe harbor which permits the recipient of the profit interests to treat the interest as having a value equal to its liquidation value (typically zero). However, in order for such treatment to apply, a number of conditions would need to be met:
  - a. the partnership must elect that the safe harbor apply;
  - b. the partnership agreement must contain provisions authorizing the election of the safe harbor and requiring the partnership and all of the partners to comply with the conditions of the safe-harbor;
  - c. the interest cannot relate to a substantially certain and predictable stream of income from partnership assets;
  - d. the interest cannot be transferred in anticipation of a subsequent disposition (subject to a presumption if the interest is transferred within 2 years of);
  - e. the interest cannot be an interest in an publicly traded partnership.

See Prop. Treas. Reg. § 1.83-3(l) and the proposed revenue procedure contained in Notice 2005-43.

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