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43rd William and Mary Tax Conference

Executive Compensation
Dealing with the new law and other developments

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I. Tax Relief Act of 1997

A. Capital Gains Rate Reduction

Under prior law, an individual's net capital gains for assets held more than one year were taxed at the lower of their marginal tax rate or 28 percent.

The new law reduces the maximum rate on net capital gains of an individual from 28 percent to 20 percent, but it increases the holding period for assets to more than 18 months.

These rates will apply for both regular and alternative minimum tax purposes, which means that there is no AMT adjustment for the new capital gains rates.

Comment: Companies should review the use of non-cash compensation in executive compensation programs. Incentive stock options will be more desirable because they can qualify for preferential capital gain treatment. In the case of restricted properties, there will be more of an incentive to freeze the compensation element through a Section 83(b) election. These issues are discussed in more detail later in this outline.

B. Educational assistance:

The law further extends the tax-favored treatment of employer-provided educational assistance under Section 127, continuing the exclusion from gross income for up to $5,250 of employer-paid tuition assistance for undergraduate courses begun by May 31, 2000.

C. Home Office Deduction

Under prior law, a person may be allowed a deduction for business expenses associated with the business use of a portion of their home. A deduction is

allowed only with respect to the portion of the home that is used exclusively and regularly in one of three ways:

- the portion of the home is considered the principal place of business for a trade or business;
- it is used to meet with patients, clients or customers in the normal course of the taxpayer's trade or business; or
- the portion so used constitutes a separate structure not attached to the dwelling unit.

For tax years beginning after December 31, 1998, the new law allows a home office to qualify for deductions under an expanded definition of a principal place of business. The new definition includes areas exclusively used to conduct administrative or management activities of a trade or business if there is no other fixed location of the trade or business where the taxpayer conducts substantial administrative or management activities of the trade or business. Employees are allowed similar treatment only if such exclusive use is for the convenience of the employer.

Comment: This rule will permit some individuals to conduct minimal paperwork at a fixed location of the business without jeopardizing the home office deduction. Additionally, services or meetings with customers, clients or patients may take place at a separate fixed business location.

Comment: This provision will aid the growing number of individuals who manage their business activities from home and is responsive to the information revolution. In addition, it allows more people business deductions when they work at home via the computer. Typical expenses that are deductible in connection with a home office deduction include a portion of rent, depreciation, repairs and a portion of utilities.

D. Parking Benefits

Current law provides an income exclusion of up to $165 per month for employer-provided parking. For the exclusion to apply, however, the parking must be provided in addition to, and not in lieu of, any compensation otherwise payable to the employee.

For tax years beginning after 1997, this restriction is eliminated. Instead, an employee may be given a choice between cash and parking, and the amount of cash offered is includible in income only if the employee chooses the cash instead of parking.

This change is intended to reduce the use of parking as a fringe benefit, on the assumption that more employees will elect to receive the cash if offered a

choice, which will increase taxable compensation. The provision is also designed to encourage use of mass transit. (Act Sec. 1072; Code Sec. 132)

E. Deductions for Business Meals

In general, subject to several exceptions, current law provides a 50% deduction for the cost of meals consumed while away from home on business. Beginning in 1998, the deduction is gradually increased to 80% by 2008, for individuals who consume meals while away from home and who are subject to the hours-of-service limitations issued by the Department of Transportation.

These workers include air transportation employees such as pilots, crew, dispatchers, mechanics and control tower operators; interstate truck operators and interstate bus drivers; railroad employees such as engineers, conductors, train crews, dispatchers and control operations personnel; and certain merchant mariners. (Act Sec. 969; Code Sec. 274(n)).

F. Employer-provided meals.

Employee's meals that are excludable from their income as "de minimis" fringe benefits are fully deductible by the employer, rather than being subject to the 50% limitation imposed by Section 274. In addition, meals provided for the convenience of the employer generally are fully deductible.

The Act clarifies that meals provided for the convenience of the employer at an employer operated eating facility are treated as if the employee paid an amount based on the direct operating costs of the facility providing the meal. This rule will make it easier for an employer facility that serves employee's meals to qualify as a "de minimis" facility so that the costs of all meals served at the facility will be fully deductible.

G. Company-owned life insurance (COLI)

The new law places further restrictions on deductions for interest incurred with respect to COLI. Tax rules regarding COLI have undergone significant changes in recent years. Companies that use COLI — and especially leveraged COLI — in their executive benefit arrangements will want to study these latest changes carefully and take appropriate action.

H. Retirement Plan Provisions

1. Diversification of Section 401(k) Investments

The new law limits the extent to which a company can mandate that employees invest their contributions to Section 401(k) plans in company stock. Under the new law, the amount of elective deferrals to a Section 401(k) plan required to be invested in "qualifying employer securities" or

"qualifying employer real property" will be limited to 10 percent of total deferrals and earnings for plan years beginning after 1998.

Three categories of plans, however, will not be subject to this constraint. These categories include ESOPs as well as individual account plans with assets that do not equal or exceed 10 percent of the fair market value of all pension plan assets of the employer. Individual account plans also will escape this rule if elective deferrals required to be invested in employer stock or real property do not exceed more than one percent of an employee's compensation.

Observation: Most employers should find that their plans will not be constrained by these limits. Plans that permit all elective deferrals to be invested at the discretion of the participant will, of course, not be subject to these new rules. Further, the new rules place no limits on the investment of employer-matching contributions in employer stock.

2. Excess Distribution Tax

The 15-percent excess distribution tax has been repealed for distributions received after 1996. The 15-percent excise tax on certain retirement accumulations in an individuals estate has also been eliminated for persons dying after 1996.

Observation: As a result of this change, tax and estate planning will no longer need to focus on the timing and form of distributions to avoid these excise taxes. The advantages of leaving retirement money in a qualified plan or individual retirement account to reap the benefits of tax deferral will continue to play a significant role in tax planning. The lowering of the capital gains rate, however, will inject a new element into this decision-making process

3. Lump-Sum Cashouts

Plans will be permitted to cash out employees with lump sums of $5,000 or less, starting with plan years beginning after the date of enactment.

Observation: This increase in the lump sum limit will provide a great deal of administrative (and some monetary) relief for employers that have had to maintain records, provide reports, pay PBGC premiums, etc., over the years for employees with small accrued benefits. Employers that have no cashout provision in their plans at present may wish to consider implementing such a provision. Employers with plans that reflect the $3,500 limit may want to amend their plans to increase the limit.

II. Compensation Issues Dealing with Capital Gains

A. Deferred Compensation Versus Current Receipt

The new lower capital gains rates have created renewed interest in the desirability of deferring compensation versus current receipt of compensation and after-tax investment of the net proceeds.

Several factors make deferred compensation appealing:

- Individual tax rate differences. Instead of recognizing compensation currently and paying tax under effective tax rates that exceed 40%, a nonqualified deferred compensation plan allows an employee to shift income to years in which he or she likely will be subject to a lower marginal tax rate (e.g., because a lower tax rate would apply to a presumably lower post-retirement income).

- Before-Tax Compounding. If an employee defers his or her compensation and the employer provides a market rate of return on the money, the amount the employee receives is substantially enhanced because earnings accrue on a before-tax basis.

- Choice of Investment. Many deferred compensation plans are structured so as to give employees some choice as to the investments made with the deferred funds, thereby giving them much of the same flexibility they would have enjoyed with their own investment portfolio.

- Qualified plan cutbacks. OBRA '93 reduced to $150,000 the amount of compensation that may be taken into account when calculating contributions or benefits under a qualified pension or profit-sharing plan. Deferred compensation plans that are designed to supplement qualified plans are known as "Top Hat Plans", "excess benefit plans" or "SERPS" (supplemental retirement plans).

- Deduction limits. Section 162(m) prohibits publicly-held corporations from deducting compensation in excess of $1 million for the top-5 employees. This limitation is measured on a "when paid" basis. By deferring employee compensation to a year in which his or her compensation does not exceed $1 million, or to a year in which the employee is not a top-five executive, a company can preserve its deduction.

- Flexibility. Deferred compensation arrangements generally do not have to meet the ERISA funding, employee coverage, and other requirements which "qualified" plans must satisfy. This exception is known as the top hat exemption.

- Economics. The ERISA exemption also makes deferred compensation arrangements inexpensive to administer and operate. Further, qualified plans require certain funding commitments. Once funded, those assets are not available to be used to satisfy other unrelated corporate obligations. Deferred compensation arrangements, on the other hand, can be structured so that the funds are available for general corporate operating purposes.

Several factors make deferred compensation less appealing:

- Loss of capital gain tax rate. Payments out of a deferred compensation plan will always be treated as ordinary income. Thus, the participant has lost the benefits of the new lower capital gains tax rates.

- Risk of corporate creditors. Successful tax deferral is only obtained if the promise is subject to general corporate creditors. Thus, an employer's bankruptcy or insolvency may cause a loss of promised payments.

- Postponed deduction. The employer's deduction is postponed until the income is recognized by the employee. While not necessarily disadvantageous if the promise is unfunded, it can result in a significant time value detriment where assets have been set aside.

- Payment time is fixed. In order to avoid constructive receipt, the plan may not allow the employee ready access to the funds.

- Problems for controlling shareholders. The IRS and the courts have consistently denied tax deferral where the individual deferring the compensation was a controlling shareholder. See, e.g., Rev. Rul. 72-317, 1972-1 CB 128.

B. Categories of Deferred Compensation Arrangements

Two general categories of deferred compensation plans exist - elective and non-elective.

Elective deferred compensation plans allow an employee to choose tax-deferred savings. This type of plan is attractive because it allows an employee to decide how much to defer. The advantages of elective deferral depend largely on an employee's present and anticipated income, living expenses, tax liability and return expected on the deferred funds.

Nonelective deferred compensation plans do not give the employees the choice to receive compensation currently. Rather, the employee participates in the plan under terms set up by their employer. This type of plan often is used by a company to provide additional incentive compensation, spreading the cost to the company over a number of years. Nonelective deferrals may also be used as a mandatory or supplemental savings plan for employees. For example, excess benefit plans or SERPS are nonelective deferral plans put in place by an employer to supplement its employee's retirement income streams.

C. Federal Income Tax Consequences

Because they are cash basis taxpayers, an employee will generally be taxed only when deferred compensation payments are actually received. Under matching rules, an employer will receive a deduction in the taxable year in which the compensation is paid to the employee. See Sections 83(h) and 404(a)(5). While this is the general rule, this tax treatment is contingent on the employee not being in "constructive receipt" or gaining other "economic benefit" from the arrangement.

1. Constructive Receipt.

Sec. 451(a) provides that a cash basis individual taxpayer is taxed only when he or she receives an item of income. However, if an individual "constructively receives" the income, it is taxed prior to actual payment (Reg. Sec. 1.451-2(a)). Income is constructively received when it is set aside for the individual, credited to his or her account, or made available without any substantial restrictions on the individual's control over the income.

Example: Bob is due a $50,000 bonus. Under the terms of the bonus declaration, the amount is scheduled to be paid upon Bob's retirement 5 years hence. However, Bob is given the ability to take payment sooner if he wishes. Even though Bob has not received actual payment, the ability to draw on the funds has placed him in constructive receipt. Thus, he will be taxed in the year the funds were first made available to him.

i. Early exits

In contrast, if the ability of a participant to withdraw funds from a deferred compensation promise are limited to situations in which they have suffered a hardship, constructive receipt will not be deemed to have occurred. In order to utilize this opportunity, it is important that

such a withdrawal be made only in the event of an unforeseeable emergency beyond the control of the employee. See Rev. Proc. 92-65.

Its has also become more common to allow participants access to their funds for any reason if they are willing to pay a penalty to do so. Such a penalty is arguably a "valuable economic right" that must be surrendered. Hence, the employee is not in constructive receipt under Section 451.

ii. Contrast with substantial risk of forfeiture

The concept of constructive receipt is often confused with that of "substantial risk of forfeiture" as defined in Section 83(c)(1). While both deal with the timing of taxation in compensatory transfers, they apply to different situations. Because substantial risk of forfeiture acts to postpone the taxation of an actual property transfer due to vesting or other restrictions, it is inapplicable where the employee has merely received a contractual right to money in the future. See Reg. Section 1.83-3(c) which exempts unfunded promises to pay property or money in the future from the definition of property.

iii. Impact on variable plans

In many variable plans, e.g. stock appreciation rights (SARs), phantom stock and performance plans, the participant is given the right to withdraw part or all of the balance in their account. In the case of SARs, the IRS has held that such a withdrawal right will generally not put the employee in constructive receipt. Rev. Rul. 80-300, 1980-2 C.B. 165, holds that the surrender of the SARs would result in the loss of a valuable right, i.e., the right to future appreciation without risking capital. Consequently, because the economic opportunity created by the SAR could not be duplicated elsewhere, the employee was not taxed, despite the fact that he or she could "cash in" the SAR without terminating employment.

However, in the case of a phantom stock plan that provides employees with units with a value measured by the value of the underlying stock, the IRS has held that such a withdrawal right will put the employee in constructive receipt because such an investment might be duplicated elsewhere. See PLR 8829070. Thus, in order to avoid running the risk of constructive receipt in phantom stock plans, the employee should be required to lose some other right, e.g. continued plan participation if they choose to withdraw their plan balance.

2. Economic Benefit.

Based primarily on case law, the economic benefit doctrine is similar to constructive receipt but has less precedent. Specifically, economic benefit occurs when an employee receives a nonforfeitable right that is equivalent to cash. If in the example above, Bob was not given the right to withdraw the bonus currently, but was given the ability to borrow $50,000 from the employer with the deferred compensation promise acting as the only collateral, Bob may be deemed to have received current economic benefit from the promise and would be taxed up-front.

D. Funding or Securing Nonqualified Deferred Compensation Plans

Funding in the case of nonqualified deferred compensation plans generally involves earmarking or setting aside funds in an account for the benefit of an employee. The following tests must be met:

- the assets used to fund the plan must be subject to the general creditors of the employer and not irrevocably set aside in a trust or escrow account, and;

- the employee may not have access to assets that the employer uses to fund the promise to pay.

E. Making The Election

An election to defer compensation generally should be made prior to the tax year in which the services are rendered. An agreement formalizing the election should be signed concurrently.

Rev. Rul. 60-31 discusses the concept of constructive receipt. According to the ruling, constructive receipt is found if an individual selects the year in which income is reported or postpones receipt of income from one taxable year to another by private agreement. A determination of whether the doctrine of constructive receipt exists is made on a case-by-case basis. The IRS occasionally has allowed deferred compensation agreements to stand even though an employee decided to defer compensation after the services were rendered. In *Veit v. Comr.*, 8 T.C. 809 (1947) acq. 1947-2 C.B. 4, a deferred compensation contract provided that an employee could defer compensation from one year to the next. The court found no constructive receipt even though the deferral agreement had been entered into after he had performed most of the services for which he was to be compensated. However, the court noted that the amount being deferred was not determinable at the time of the agreement.

In *Martin v. Commissioner,* 96 T.C. 814 (1991), the Tax Court dealt with an employer who replaced its equity-based deferred compensation plan with a slightly different plan, one difference of which was the ability of the employee to elect a lump-sum or installment payout. After two employees elected the installment option and then terminated their employment, the IRS challenged the tax deferral. The Tax Court held that the installment election made by the taxpayers was effective, despite the Service's allegation that the opportunity to elect to receive a lump sum payment after the services were performed put the taxpayers in constructive receipt.

Observation: This case if often used by compensation practitioners as precedent for "after-the-fact" deferrals, i.e. that deferrals are successful as long as the election is made before the amounts are due and payable to the employee. Because the facts in the case are somewhat unique, such a broad-based reliance may be considered aggressive. Rather, employees should be encouraged to make deferral elections as soon as possible in the earnings period.

F. Earnings on Deferred Compensation Arrangements

The flexibility generally afforded deferred compensation plans extends to methods of providing these investment returns to the employee-participant. For example, the employee may be compensated using a strict time-value approach through the use of interest. Another approach is to provide a return based upon the performance of the employer's stock. Alternatively, and now much more popular, are plans that provide a return based upon the performance of other investments such as marketable securities. In these latter arrangements, the employee is provided with the ability to manage his or her account, though the actual ownership of the underlying assets is held by the employer. See PLRs 8804057, 8952037 and 9101011

> *Example*: Bob has $200,000 in his deferred compensation account balance that provides a return based on the company's borrowing rate. To allow for diversity, his employer puts a new plan in place that allows Bob either the choice of continuing the interest-based return or investing in securities in a manner similar to that provided in the company's Section 401(k) plan, i.e., a choice of funds.

G. Securing an Employee's Deferred Compensation

The main drawback of nonqualified deferred compensation plans is the unsecured nature of the employer's promise to pay. While this lack of security against corporate creditors is unavoidable, several methods may be used to protect an employee against other risks or uncertainties.

1. Rabbi Trusts.

   Rabbi trusts are a popular method to provide additional security for an employer's unfunded deferred compensation arrangement without causing an employee to receive taxable income. A rabbi trust is an irrevocable trust which is treated as a grantor trust under Sections 671 and 679 because of retained powers - specifically the potential use of the funds to satisfy corporate creditors.

   In these arrangements, the employer contributes assets to a trust maintained by a third-part trustee to support its deferred compensation obligation. The assets can be used only to pay the promised deferral or to pay claims of creditors by the trustee. Thus, they are protected from management's "change of heart" or change of control (e.g., new management after a takeover or restructuring.). In other words, the employee need not fear having to sue management in order to enforce the terms of a deferred compensation contract.

   In G.C.M. 39230, the IRS stated that if a rabbi trust is properly constructed, contributions and earnings held in it are not taxable to the employee under the economic benefit or constructive receipt tests. No economic benefit is present because the trust's assets remain subject to the risk of the company's creditors in the event of insolvency. An employee does not have constructive receipt because he or she will not receive any payment currently. The IRS also determined there is no current taxable income under Section 83 because the assets are not set aside from the claims of the employer's creditors. The employer does not receive a deduction for contributions. Trust earnings are taxable to the employer under the grantor trust rules. See Rev. Proc. 92-64 for model rabbi trust language.

   Observation: Rabbi trusts are occasionally used specifically for change of control protection. In these cases, an unfunded Rabbi trust (known as a "springing trust") is established. If a change of control does occur, the trust is immediately funded, and outgoing management is assured of payment of their golden parachute benefits.

2. Secular Trusts

   Secular trusts are another method used to provide security for an employer's unfunded deferred compensation arrangement. However, this type of trust causes current taxation to the employee because the assets are protected.

   Like the rabbi trust, the secular trust is irrevocable. Unlike a rabbi trust, however, the assets held in a secular trust are not subject to the claims of

creditors. Consequently, a secular trust offers an employee more security because it protects the employee against the employer's breach of promise and its insolvency.

Contributions to the trust are currently taxable to the employee because he or she is considered to have constructively received the benefits. In addition, highly compensated employees are taxed annually on the trust income distributed to them during the year as well as the increase in their share of the trust value at year-end (the increase in their "vested benefit"). See Section 402(b)(4). Further, the trust is taxed on any income earned yet not distributed. Thus, the income has the potential to be double taxed. For this reason and because of other complexities that affect the employer's deduction for these benefits, secular trusts are seldom used.

3. Guarantees

Guarantees by an unrelated shareholder or party are occasionally used to secure an employer's promise of payment and may not result in current taxation of the compensation. For example, in *Berry v. U.S.*, 760 F.2d 85 (4th Cir. 1985), the guarantee of a ballplayer's deferred compensation by the team owner did not result in current taxation. In PLR 8509023, the IRS stated that no current taxation would result where a parent company guaranteed its subsidiary's deferred compensation agreement.

4. Surety Bonds

Surety bonds, letters of credit and similar instruments can also offer protection against an employer's insolvency. In PLR 8406012, the IRS approved the purchase of a surety bond by an employee and ruled there was no current taxation despite the fact that while the bond was outstanding the employee had effective protection against the employer's insolvency. The IRS decision turned on the fact that the employee purchased the surety bond. In PLR 9344038, the IRS released a similar conclusion, even though the employer provided the employee with a bonus that was used to purchase the bond. As a practical matter, however, surety bonds are very costly and offered by only a few insurers.

H. Reporting and Withholding on Deferred Compensation

Because these arrangements are nonqualified, any payment made to employees are treated as wages for purposes of reporting and withholding of federal income taxes. As a result, these payments are subject to the withholding of federal income tax at the time of payment. The amount of withholding depends upon the employment status of the recipient. If they are currently employed by the payor, the payment is eligible for withholding at the

supplemental rate (currently 28% - see Reg. Section 31.3402(g)-1.) Alternatively, withholding can occur at the rate provided in the withholding tables.

Unlike qualified plan distributions which are reported on Form 1099R, nonqualified deferred compensation payments are reportable on Form W-2, even where the individual is no longer in the employ of the payor (see the instructions for Form W-2 where a reporting box is provided for nonqualified deferred compensation payments.)

I. Effect of ERISA on Nonqualified Deferred Compensation Plans

ERISA Section 201(2) exempts from virtually all of its requirements an unfunded arrangement maintained "primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees." If a plan qualifies under this exemption, it will be exempt from the participation, vesting, benefit accrual, funding and fiduciary provisions of ERISA. The plans are, however, subject to ERISA's reporting and disclosure and administration and enforcement provisions.

An employer who maintains such a plan may satisfy the reporting requirements of Title I of ERISA with respect to such a plan by filing with the Department of Labor a single statement at the plan's inception that includes the employer's name, address, identification number and a declaration that the employer maintains the plan primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees, the number of such plans maintained by the employer and the number of employees in each plan.

J. Effect of lower capital gains rates explored

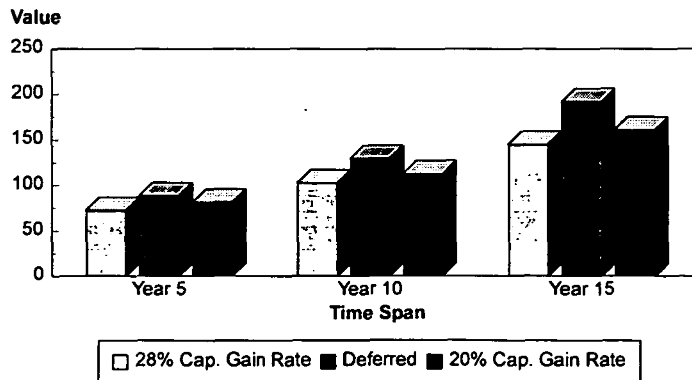
Despite the new lower capital gains tax rates, a present value analysis of compensation deferral versus current receipt and after-tax investment generally reveals that the executive continues to be better off by deferring his or her compensation.

Of course, the executive must consider the inflexibility of a fixed payment date, the risk of the employer's creditors and the potential availability of higher yields outside of the plan in the decision process of whether or not to defer.

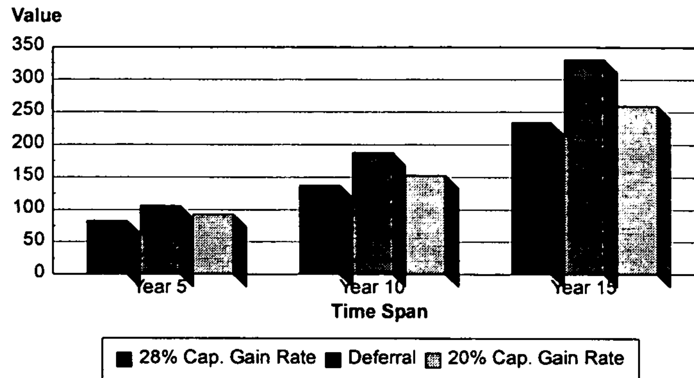
1. Some comparisons

Based on $100,000 deferral using maximum tax rates (no state tax)

	5 years	10 years	15 years
At 8%			
deferred	$88,747	$130,399	$191,599
paid and invested in ord. inc. invest.	76,473	96,822	122,587
paid and invested in cap gain invest.	81,579	113,923	161,447
At 10%			
deferred	$97,275	$156,662	252,306
paid and invested in ord. inc. invest.	80,981	108,576	145,574
paid and invested in cap gain invest.	86,827	132,105	205,025
At 12%			
deferred	$106,445	$187,593	$330,603
paid and invested in ord. inc. invest.	85,700	121,599	172,534
paid and invested in cap gain invest.	92,370	153,134	260,220



Old and New Law compared (at 12%)



K. Property Transfers and Capital Gains

General: An employee is taxed on the compensatory receipt of property unless the property (usually stock in the employer) is transferred subject to a "substantial risk of forfeiture". The most common example of a substantial risk of forfeiture is a service term, i.e., the employee will forfeit the property unless they complete a pre-specified employment period. Therefore, the risk provides an incentive to the employee, if he or she does not satisfy the condition, the property must be returned to the employer.

1. Employee's tax treatment:

   Unless an election is made by the employee to accelerate taxation, there is no tax at the time of grant, but the employee is liable for tax at *ordinary income tax rates* on the full stock value at the time of vesting.

2. Election under Section 83(b)

   As an alternative to the above tax treatment, an election is permitted under Section 83(b) to disregard the presence of the substantial risk of forfeiture. Under this rule, the employee must elect within 30 days of receipt of the restricted stock to be taxed at the time the stock is granted. The excess of the fair market value of the stock (computed without regard to the restrictions, except for restrictions which will never lapse) over the

employee's cost will then be treated as compensation income in the year of receipt.

If the restricted stock is subsequently forfeited, the employee may not claim a deduction for the amount previously included in income. However, he may treat as a capital loss the amount paid (if any) for the stock (Reg. Sec. 1.83-2.)

i. Why make the election?

Closing the taxable event under §83 early gives employees the opportunity to limit their ordinary income from the transaction to the value at the date of the property transfer, shifting any future appreciation into capital gain

ii. Even when fair market value is paid for the stock?

The importance of considering the §83(b) election in every restricted property transaction, even if there is no spread at transfer. Although the statute may be read to preclude an election where there is no spread, the regulations permit such an election. In fact, the Tax Court in *Alves v. Commissioner.* , 79 T.C. 864 (1982), approved this position, holding that, unless an election is made on the facts of the above example, the spread at the lapse of the restrictions is taxable as compensation income, despite the absence of a spread at exercise.

iii. 83(b) elections on stock options

Option holders often suggest making a Section 83(b) election at the time stock options are granted to them as a way to convert option appreciation into capital gain. Unfortunately, unless the options have a readily ascertainable fair market value at the date of grant, optionholders cannot make a Section 83(b) election. See *Cramer v. Comm.*, 101 TC 225.

In *Cramer*, the taxpayer was the founder and chief executive of a corporation engaged in the manufacture and sale of electronic medical instruments. In 1978 and 1979, the corporation gave the taxpayer options to purchase 54,000 shares of its stock. Both options were exercisable in 20% increments in each of the next five years provided that the taxpayer was employed by the corporation at the time of exercise. The options could be transferred only to persons approved by the board of directors and a transferee took the options subject to the taxpayer's restrictions. In 1981, the corporation issued an option for 325,000 shares to a trustee for the benefit of the taxpayer and certain executives and directors. The option could be exercised only in

one-third increments in 1983, 1984, and 1985. A separate agreement among the beneficiaries provided that individuals no longer employed by the corporation on an exercise date would lose their share of the option.

The taxpayer filed a Section 83(b) election for the 1978 option, reporting its value as zero. The taxpayer did not report any income from the receipt of the other options. In 1982, the corporation was purchased by a public company that paid the taxpayer $25.9 million for the options. The taxpayer claimed a capital gain, although this was contrary to Reg. 1.83-7. The conflict was not disclosed and the sale was reported on a section of the return designated for stocks and bonds.

The Tax Court held that the options did not have a readily ascertainable FMV under Reg. 1.83-7(b) so the taxpayer recognized ordinary income on the sale. The Ninth Circuit affirmed, holding that the Regulation was valid.

L. Incentive Stock Options.

Incentive Stock Options (ISO's) are contractual promises that permit an employee to acquire stock from the employer at a future date under pre-established terms. However, because they meet stringent restrictions and conditions, they are not taxable for regular tax purposes at either the grant or exercise dates.[1] Instead, if the stock received as a result of the exercise is held at least two years from date of grant and one year from the date of exercise, the employee will only recognize capital gain when the stock is sold in an amount equal to the excess of the stock's selling price over the exercise price.

If the holder of stock received pursuant to the exercise of an incentive stock option fails to meet these holding period requirements, they are deemed to have disposed of the stock in a "disqualifying disposition". As such, the previous exercise of the option will generally be treated as if the option were nonqualified. This issue is discussed in more detail below.

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[1] See Section 422 for the ISO requirements. The most important of these requirements are that the options exercise price at least equal the stock's fair market value at date of grant, that the option be exercised only while the individual is employed (or within 3 months of termination), and that options granted to an employee that are exercisable in any one year be capped at no more than $100,000 in underlying stock value.

1. Limitation on Options to Be Exercised

The value of shares of employer stock that can be exercised for the first time by a taxpayer in any one year under an ISO cannot exceed $100,000, based on the fair market value of the stock at the date of the ISO's grant.[2]

> Example: X Corp. grants 5,000 options to purchase shares of X Corp. to A on December 31, 1995, which are immediately exercisable at a price equal to the fair market value of the stock on the date of grant. As long as the stock price of X Corp. stock on December 31, 1995 was $20 per share or less, the options can be ISOs.

Options granted in excess of the $100,000 limitation are treated as nonqualified stock options.

2. ISO's and the AMT

While the exercise of an ISO does not result in current taxable income, there are implications with regard to the alternative minimum tax (AMT). When calculating income for AMT purposes, the favorable tax treatment of §421(a) is disregarded and the bargain purchase element of the ISO will be considered as part of AMT income.[3]

- The "spread" between the option price and the fair market value of the option stock at exercise is treated as an "item of adjustment" for AMT purposes.

3. Make 83(b) elections on ISOs

A common strategy is to allow employees to exercise options before they have vested in the shares. The shares are then held in an escrow account and distributed as they are vested.

Coupled with this strategy is the idea to make a Section 83(b) election at the time of exercise. Since the exercise in this scenario usually takes place as soon as the stock option is granted the spread is usually zero. No income for regular tax purposes, nor for alternative minimum tax purposes is recognized.

> Comment: Companies, or more specifically, their boards, should be aware that this strategy will usually prevent a sizable deduction.

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2 § 422(d).

3 § 56(b)(3).

Finally, many companies also allow employees to borrow the exercise price through a note with the company. This notes should, of course, be recourse or IRS can conclude the options were never exercised.

4. Basis of Stock

For regular tax purposes, the basis of the stock to the employee will be the amount the employee paid upon exercise of the ISO provided a "disqualifying disposition", as discussed below, has not occurred.[4] For AMT purposes, the basis of the stock is equal to the exercise price plus the AMT income recognized.

5. Disposition of Stock

The tax treatment of the disposition of stock depends upon whether the stock was disposed of within the statutory holding period for ISO stock. The statutory holding period of stock acquired pursuant to the exercise of an ISO is two years from the date the ISO was granted to the employee and one year from the date of exercise.[5]

If the employee disposes of ISO stock after the statutory holding period has been met, the employee will recognize as capital gain or loss the difference between the amount received over the basis in the option stock.[6]

6. Disqualifying Disposition

If an employee disposes of the stock before the requisite holding period is met, it is considered a disqualifying disposition.

The employee must recognize as compensation income the lesser of the difference between the option's exercise price and the stock's fair market value on the date of exercise (the "bargain element") and the amount realized on the sale or exchange over the adjusted basis of the stock. If the gain on the disposition of such stock exceeds the amount reported as compensation income, such excess is treated as a capital gain.

i. AMT Considerations

If a disqualifying disposition occurs in the year in which the option is exercised, the maximum amount that will be included as AMT income is the gain on the disposition of the ISO stock.

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4 § 1011.

5 § 422(a)(1). See also Prop. Reg. 1.422A-1(a)(1)(i)(A).

6 See § 1001(a).

Should there be a disqualifying disposition in a year other than the year of exercise, the income on the disqualifying disposition will not be considered income for AMT purposes.

The basis of the ISO stock for determining gain or loss for AMT purposes will be the exercise price for the ISO stock increased by the amount that AMT income was increased due to the earlier exercise of the ISO.[7]

Example: In 1996, A paid $2,000 to exercise 200 ISOs for X Corp. stock at $10 per share when the fair market value of X Corp. stock was $15. In return, A received shares with a fair market value of $3,000. In calculating A's AMT, $1,000 will be added as an item of adjustment.

If A makes a disqualifying disposition of the ISO stock in 1997, the $1,000 that was recognized as compensation income in 1996 will not be reflected in the calculation of taxable income for AMT purposes in 1997.

If, however, A does not make a disqualifying disposition and sells all his ISO stock after the expiration of the ISO holding period at $20 per share, the gain on the sale of stock for AMT purposes would be $1,000. ($4,000 of proceeds on sale, less $2,000 (the cost basis of stock) and less $1,000 (the amount previously recognized as AMT income)).

ii. Effect on Employer

The employer may deduct from income in the year of a disqualifying disposition the amount the employee recognizes as compensation income.[8]

M. Stock Swaps and Pyramiding

1. "Pyramiding" with ISOs

i. Use of Stock for Option Exercise Price

An ISO plan can provide that the employee may pay for the exercise of his options with stock of the employer corporation. The use of stock which has appreciated in value in an ISO exercise is advantageous to

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7 § 56(b)(3).
8 § 421(b).

the employee since there is no gain recognized by the employee on the use of this stock which has appreciated in value. The number of shares of stock received in the exercise of the ISO equal to the number of shares used to exercise the ISO has a basis in the stock equal to the basis that the employee had in the stock used in the exercise. The remaining shares of stock have a basis equal to the gain, if any, on the exercise of the ISO and any cash paid on the exercise.

> Example: A, an employee of X Corp., owns 1,000 shares of X Corp. stock (which he purchased) that have a basis of $10 per share. A also has 500 ISOs for one share of X Corp. stock each, with the exercise price being $15. A decides to exercise all his ISOs when the market price of X Corp. stock is $20. X Corp.'s ISO plan provides that stock of X Corp. can be used to pay the ISO exercise price. A tenders 375 shares of X Corp. stock he already owns to X Corp. as payment of the total ISO exercise price of $7,500. A recognizes no taxable income on either the transfer of the stock to exercise the ISOs or on the exercise of the ISOs. A's basis in 375 of the ISO shares will be $10 per share and A will have a zero basis in the remaining 125 shares.

2. Limits on Stock Pyramiding

The general rule is that a disqualifying disposition does not occur upon the exchange of ISO stock for similar company stock if the transfer:

- is a transfer by a decedent to an estate or a transfer by bequest or inheritance;
- is pursuant to a transaction to which §§354, 355, 356, or 1036 (or so much of §1031 as related to §1036) applies; or
- is a mere pledge or hypothecation.

However, if ISO stock (or the stock received through the exercise of a restricted or qualified stock option) is used in the exercise of an ISO when the holding period requirement is not met, such use will be considered a disqualifying disposition.

> Example: Assume the same facts as the previous example, except that A received the 1,000 shares that he owned from the exercise of options granted 18 months ago. A would still not recognize any income on the exercise of the 500 ISOs. However,

since the use of the 375 shares of ISO stock was a disqualifying disposition, A would recognize income equal to the bargain purchase element on the 375 shares used in the new ISO exercise.

3. Pyramiding with Nonqualified Stock Options (NQSOs)

Pyramiding with NQSOs may permit an employee who has little existing employer stock to acquire that stock through a pyramiding transaction.

Example: L, a key executive of P Corp., owns 1,000 shares of P common stock that he purchased for $10 per share in 1986. On July 1, 1996, P grants to L nonqualified options to purchase 1,000 shares of P common stock at $20 per share. On that date, the fair market value of the P stock is $20 per share. On June 30, 1998, when the fair market value of the P stock is $40 per share, as permitted under the terms of the P option plan, L tenders to P 500 shares of the previously owned P stock (fair market value $20,000) to exercise the options for 1,000 shares of P stock (exercise price $20,000).

If an employee can purchase one share of employer stock, he can use that share to exercise two options, then use the two shares to exercise four options, and so forth. In effect, without having the substantial investment in existing shares that was present in the ruling, an employee could fully exercise all 1,000 options. Of course, so long as the options are nonqualified, in each successive exercise, compensation income would be recognized under §83(a).

4. Accounting Issues

Exponential stock pyramiding creates accounting problems for the employer as each successive exercise is treated separately. For this reason, stock pyramiding is rarely used.

III. Other Compensation Planning Strategies Involving Options or Stock

A. Conversion of Option Spread into Deferred Compensation

Considerable attention has been focused recently on a tax-deferral strategy that allows executives to convert their stock option gains into a deferred compensation promise.

Facts: An executive of a publicly traded company currently holds a significant number of stock options in that company. The company's stock has substantially appreciated in value subsequent to the time the option was granted. The options are due to expire shortly. However, the executive prefers not to exercise the options and is seeking a way to retain the benefits of an option holder after the option's expiration date without tax consequence.

In order to accomplish these objectives from a federal income tax prospective, it is essential that the options be converted into a form of deferred compensation and never be converted into property that is owned by the executive.

Specifically, Section 83 provides that an individual is taxed at such time as they have an actual or beneficial interest in property. Options, however, are not considered property. Rather, if they meet certain tests contained in Reg. Section 1.83-7, they fall into the category of an unfunded, unsecured promise to pay property in the future (which is subject to tax only when cash or property is actually or constructively received by the employee). Those regulations hold that options may only be taxed at the time the option is exercised or disposed of in an arm's length transaction.

Thus, the only way to avoid the acceleration of taxation to the individual is for the individual to remain a general, unsecured creditor of the company and not exercise or dispose of the option in an arm's length transaction. The argument is that if the individual swaps a promise in the nature of the stock options for another promise, and remains a general unsecured creditor of the company, taxation has arguably been deferred.

This technique could simply be accomplished by canceling an option by advance election and converting the spread in that option into a deferred compensation plan whose payout is expressed in the any form, including stock of the employer or any other type of investment. However, such a structure will result in unfavorable accounting consequences.

The following structure, however, should allow tax deferral and may result in favorable accounting to the extent the promise remains in the form of company stock.

1. Illustrative Structure

Some time prior to exercise (as long as possible, though 6 months is generally suggested), the employee makes an advance election to utilize the deferred compensation feature that will take effect if they later choose to exercise options.

At the time of exercise the employee tenders to the employer "mature" shares (per the financial accounting rules, shares owned by the employee for more than six months or purchased in the open market) for the full option exercise price.

The employer sets up a deferred compensation plan whose benefits will be expressed as units of phantom stock. The employee's units in the account will equal the option spread for the options exercised above divided by the company's stock price on that day.

At the time of the deferral, the employee will elect when such units are to be paid.

Cash dividend equivalents during the deferral period may be booked to the account as reinvested in company stock or invested in other vehicles within the nonqualified deferred compensation plan.

Plan payments cannot be disbursed to the employee for a number of years specified in the deferral agreement (e.g., 5 years) or until a specified event occurs (e.g., retirement). Exceptions can be made for unforeseeable emergencies or if a sufficient penalty (e.g., loss of 10%) is imposed on the employee.

To the extent investments are diversified away from company stock, any gains, losses or investment income realized from non-employer securities would be reported by the employer for income tax purposes. Note that the diversification approach will preclude favorable accounting under recent EITF and FASB actions

2. Key Issues

- From an overall business perspective: whether such a program is compatible with the company's incentive compensation objectives, and how it will be perceived from a shareholder/public perspective.

- Financial accounting issues: whether the program will result in a compensation charge for the value of the options at the time of exercise

(i.e., a new "measurement date") under APB 25.

- From a tax perspective: whether "constructive receipt" of the compensation is avoided.

It may be possible through proper structuring to avoid an earnings charge under APB 25, although this issue is the subject of debate and should be reviewed by your accounting advisors. As stated above, the EITF and FASB are indicating that no accounting charge results if the deferred compensation balance is expressed as company stock value.

From a tax perspective, three features arguably ensure continued deferral: First, having the employee elect to use the deferred compensation feature sufficiently in advance of the exercise of the options. Second, having the deferred compensation remain unsecured, subject to general creditors' claims. Third, preventing the employee's ready access to the funds without penalty for a specified period time.

Although income tax would be deferred, FICA may apply for employee participants when amounts are recorded under the nonqualified deferred compensation plan unless the plan contains a substantial risk of forfeiture. If FICA is paid up front on the nonqualified deferred compensation plan balance, no FICA tax will accrue to subsequent related earnings in the plan.

Note that employees can generally use appreciated employer stock already held to fund the exercise price of nonqualified stock options ("pyramiding") without recognizing taxable gain on the stock (Rev. Rul. 80-244). Finally, the tax accrual and the effective tax rate should not be peculiarly affected. When actually realized (when the compensation is paid), the tax benefit related to the value of the options will be reported directly to equity (not through the income statement if there is no corresponding earnings charge); the tax benefit on the subsequent deferred compensation build-up will be accrued as a deferred tax asset and reversed when the compensation is paid.

B. Gifting Compensatory Stock Options

The fundamental objective of a effective lifetime estate plan is the shifting of potential asset appreciation out of an individual's estate. When designing a gifting program to meet this objective, the ideal assets to use are those that have a low current value but high potential appreciation. Compensatory stock options held by an executive are often the perfect candidate for this mission. Options have the unique attribute of allowing the executive to participate in corporate appreciation without an up-front cash outlay. Thus, they generally have a relatively low value as a percentage of appreciation potential - much more so than the underlying stock itself.

1. Use of a Trust

Potentially appreciating stock options are transferred to an irrevocable trust set up by an executive for the benefit of his or her children or other beneficiaries. Later, when the options are in-the-money, the trustee either exercises the options and sells the stock or distributes the options to the beneficiaries for them to exercise and sell.

i. Benefits

It removes a potentially appreciating asset from the executive's estate at a relatively low gift tax cost (or at no current cost through the use of annual exclusions or unified credit). Thus, any stock appreciation is shifted to the executive's heirs and will escape the fifty-five percent federal estate tax levy as well as most state inheritance taxes.

When the option is later exercised by the trust, the executive will be taxed on the sale as if they had never transferred the stock to trust. While the trust becomes the legal and beneficial owner of the options, the executive continues to bear the tax burden up to the point of exercise. Therefore, the executive's Form W-2 will report compensation in the year that the trust (or the beneficiary) exercises the option. As a consequence of this tax, the stock's basis is stepped up in the hand's of the trust to the exercise date value. See Reg. Sections 1.83-4(b) and 1.83-1(c)

When the stock is later sold, the trust will only pay tax on the excess of the selling price over the exercise date value. Because the sale will often take place on or near the date of exercise, the holder will pay little or no additional tax and little or no withholding is required. As a result, the executive's estate is further diminished by the taxes he or she pays while the heirs enjoy the benefit of that tax in the form of the increased stock basis that reduces the gain on their stock sale - this can be viewed as an additional gift from the executive that is exempt from gift tax.

As stated above, this technique calls for the option be transferred to a trust. Because most options granted in a compensatory environment do not provide for such transferability, action must be taken to amend the stock options to provide for such a limited transfer, e.g. the options will provide that they may only be transferred to an irrevocable trust established by an executive for the benefit of a family member.

ii. Option Valuation

This technique's value is a product of the fact that the initial transfer to trust is a completed gift for gift tax purposes. Thus, any gift tax is imposed on the value of the option on day one rather than the value of the stock or its proceeds upon their transfer in the future. As a result, the value of the option is important to determine the economic effects of this transaction. While there is little precedent to value these options, consideration of their limited marketability and transferability should allow substantial discounts from the underlying stock's value. Also see Rev. Rul. 196, which holds that for estate valuation purposes the value of an option is the spread between exercise price and fair market value.

iii. Recent Rulings - transfers for benefit of family members

The IRS has issued two recent private letter rulings holding that an employee does not recognize income when he or she transfers stock options to family members or a trust for the benefit of a family member. The facts were substantially similar in PLRs 9713012 and 9714012. In each case, the employee had been granted nonqualified stock options under an employer-sponsored stock option plan. The plan or the option agreement provided that the employee could transfer the options to a member of the employee's immediate family or a trust for the sole benefit of such family member(s) without consideration.

PLR 9713012 dealt with a specific trust instrument and described its operative features, whereas PLR 9714012 discussed amending the plan to provide for such transfers generally. In addition to transferring the option to an immediate family member or trust for the benefit of a family member, PLR 9714012 also allowed a transfer of the options to a partnership composed solely of members of the employee's immediate family. Further, PLR 9713012 contemplated the transfer of vested and/or unvested stock options.

PLR 9713012 narrowly defined "immediate family" as a grantee's spouse, children and grandchildren. However, PLR 9714012 broadened this definition of "immediate family" to also include stepchildren, parents, grandparents, siblings (including half-brothers and sisters) and persons who are family members by adoption. In both PLRs, the IRS ruled that the options did not have a readily ascertainable fair market value at the date of grant. Both rulings also stated that the transfer of the options to the family member or trust would not be an arm's-length transaction and the options would not be considered disposed of under the applicable regulations. Accordingly, the transfer would not cause the employee to recognize income or gain. Rather,

the IRS ruled that the employee would recognize income or gain when the options were exercised, assuming that the employee is living at that time. If the employee is living when the options are exercised, then the transferee's basis in the stock would be the exercise price of the option plus the amount of income recognized by the transferor under Section 83(a).

In PLR 9713012, the IRS refused to express an opinion on the tax consequences to the employee or the transferee if the employee died before the options were exercised, presumably because such facts involve estate and gift tax provisions and those issues were submitted to the IRS in a separate letter. It is unclear, however, what the tax consequences would be in that situation. One possibility is that there would be no tax to the decedent's estate and the transferee's basis in the stock would be equal to the exercise price. Another possibility is that the decedent's estate would have income in respect of a decedent and the transferee's basis would be treated as if the decedent were living. A third view would be to allow the transferee a step-up in basis upon the death of the employee equal to the amount of tax that the employee would have paid upon the exercise of the option, plus the exercise price. Of particular significance in PLR 9714012, the IRS ruled that amending the stock option plan (or an outstanding option agreement under a stock option plan) to permit transfers of options to family members would not be a material modification of the plan for purposes of complying with the transition rule under Section 162(m) regarding the performance-based compensation exception to $1 million limit on the deductibility of executive compensation.

iv. Recent Rulings - transfers for benefit of charities

In PLR 9737014, dated June 13, 1997, the IRS explained two methods of making a non-arm's length transfer of nonqualified stock options that will not trigger recognition of income until the options are subsequently exercised. In both cases, the options were substantially vested. Also, in both cases, the employee-optionee-donor retained control over the timing of exercise during the employee-optionee-donor's lifetime. This resulted in the Service finding that no completed gift had been made.

Facts: In the first case, in order to remain anonymous, the donor transferred the stock options to a combined custody and brokerage account held by a financial intermediary on behalf of the employee and subject to the terms of a Gift Administration Agreement. Under the Agreement, the intermediary was required to exercise the options on a specified date, which the donor retained the ability to change. Upon exercise, the intermediary was to immediately sell the shares and

deposit the net proceeds in the Account from which a wire transfer would be made to the specified charities. The letter ruling explained the net proceeds of the sale meant the gross proceeds less the exercise prices, withholding taxes, and costs relating to the option's exercise and its transfer. We assume the intermediary paid the exercise prices and withholding taxes to the donor's employer directly.

In the second case, the optionee irrevocably donated options to a charity, but retained the power to veto the charity's proposed exercise of the options during the donor's lifetime and to designate the withholding tax rate and the spread on exercise. The charity had two methods by which it would be able to exercise the options. It could either pay the exercise price and all applicable taxes to the donor's employer and then receive the shares or it could arrange for a same day sale with a broker and have the broker deliver the exercise price and taxes to the donor's employer.

In both cases, once the donor died, the charities were free to exercise the options at any time.

Compensation and Deduction_Holdings: The Service ruled that the donors will not recognize income or gain on the transfer of the options, but that they will recognize compensatory income when the options are exercised. The amount of this income equals to the excess of the fair market value of the optioned shares on the date of exercise over the exercise price of the option.

The Service also ruled that when the exercise occurs during the optionee's lifetime, the recognized income constitutes wages for federal income tax withholding purposes under section 3401 of the Code, which is not the case if the exercise occurs after the optionee's death. In either event, however, the income will be treated as compensatory income and the employer will be allowed a deduction in an amount equal to the amount of compensation income recognized by the optionee.

Timing of Charitable Deduction, Gift Tax and Estate Tax Issues: As a follow-up, PLRs 9737015 and 9737016 cover charitable deduction and estate and gift tax issues not addressed in PLR 9737014. In both cases, the Service found that the optionee's reserved right to control the date of exercise prevents the completed transfer of the option to the charity. Accordingly, in the first instance no completed charitable contribution for purposes of section 170 occurs until the intermediary makes a wire transfer of money to the charity. In the second instance, no completed charitable contribution occurs for purposes of section 170 until the

charity exercises the options. The Service also ruled that because the character of what the charity receives is compensation and not capital gain to the donor, section 170(e)(1) does not apply to reduce the charitable contribution deduction, since the option will not have an appreciation value at the time of the contribution.

For gift tax purposes, the Service ruled similarly in the first case, that a completed gift occurs when the intermediary makes the wire transfer to the charity. However, in the second case, the Service ruled that a completed gift occurs when the donor approves the charity's exercise and designates the withholding tax rate and the spread on exercise.

Finally, for estate tax purposes, the Service ruled that in both instances, to the extent the donated options had not been exercised during the donor's lifetime, the value of the option will be includible in the donor's estate under section 2036 or section 2038 and the estate will be allowed a charitable deduction under section 2055(a) if the deduction is not disallowed under section 2055(e).