

2010

Ten Tax Strategies for Compensating Your Key Employees

Catherine M. Marriott

Repository Citation

Marriott, Catherine M., "Ten Tax Strategies for Compensating Your Key Employees" (2010). *William & Mary Annual Tax Conference*. 16.
<https://scholarship.law.wm.edu/tax/16>

Ten Tax Strategies for Compensating Your Key Employees
William & Mary Tax Conference
November 11, 2010

by Catherine M. Marriott, Esq.
Williams Mullen

I. Introduction

Compensating key employees can be challenging in light of changing tax rules, disclosure requirements for public and not-for-profit companies and today's economic difficulties. This Outline mentions several compensation alternatives that are no longer possible (or have become more difficult to implement). This Outline also discusses ways to compensate key employees for today and for the future.

II. Strategies That Are More Difficult to Use (or Can No Longer Be Used)

A. Discounted Options

1. Prior Tax Treatment. Before the enactment of section 409A of the Internal Revenue Code as amended (the "Code") in 2004 and related Treasury Regulations (together, "409A"), discounted options sometimes were granted to executives to provide measurable value as of the grant date. Increase in the stock price after the grant date contributed to the executive's compensation element ultimately provided by the option, while the initial discount offered a compensatory reward from the outset. No taxation to the employee occurred until exercise, allowing the executive to determine when and whether to recognize income.

2. Current Tax Requirement. 409A changed the tax requirements for option grants. An option that does not comply with 409A exposes the executive to income taxation and penalties regardless of whether the option is exercised. 409A requires that the option either be granted with a fair market value exercise price or that it have fixed exercise dates. 409A sets guidelines under which public and private companies may establish fair market value. Using fixed exercise dates potentially allows employers to offer discounted options without 409A penalties. Whether that structure offers adequate value to employees often depends on company- and executive-specific circumstances.

3. Accounting Treatment. Accounting treatment is an important consideration in setting all compensations strategies. Significantly, beginning in late 2005 or 2006 (depending on an employer's fiscal year), the Financial Accounting Standards Board changed the accounting treatment of employee stock options, to require even fair market value exercise price options to be expensed. The expense is not reversible if the stock's value drops below the exercise price.

This outline does not, however, detail accounting issues for executive compensation.

B. Phantom Equity Paid on Certain Common Payment Events

1. Prior Tax Treatment. Prior to 409A, phantom equity was viewed primarily as a form of equity compensation that tracked the performance of the employer's equity and was settled in cash or an interest in the company. Taxation occurred at settlement, equal to the cash and value of any property received. Phantom equity could be tied to specific performance goals (often referred to as "performance shares"), or simply to continued employment and equity price (often referred to as "phantom shares"). There was a great deal of flexibility as to the conditions on which the award would be settled, and the time at which payment would be made.

2. Current Tax Treatment. 409A treats phantom equity as deferred compensation, unless the short-term deferral rule, discussed below at Part III.E.4.c, or other exceptions apply. While the same rules apply as to when and how much income is recognized, the payment event must fit into specific categories or satisfy certain timing rules in order to avoid interest and penalties. 409A-compliant phantom equity arrangements are discussed below at Part III.F.

C. Discriminatory Health Plans

1. Prior Tax Treatment. Before the enactment of health care reform earlier this year, an employer could provide enhanced health benefits to executives through an *insured* plan. (Even under prior law, Code section 105 taxed benefits under discriminatory *self-insured* health plans, making them impracticable compensation tools.)

2. Current Tax Treatment. Health care reform requires insured group health plans to satisfy nondiscrimination requirements under Code section 105(h)(2). New types of penalties apply: the plan may be sued and required to provide nondiscriminatory benefits; the employer may be subject to excise taxes and monetary penalties. Grandfathered insured plans are exempt from these new penalties. Whether grandfathered status applies must be determined on a case-by-case basis. In Notice 2010-63, the IRS requested comments (due by November 4, 2010) on what guidance would be helpful with respect to the new nondiscrimination requirements.

III. Ten Tax Strategies for Compensating Executives in 2010 and Beyond

Despite the limitations described above, many methods of rewarding key executives in a tax-effective manner remain. Ten strategies, and related planning considerations, are discussed below.

A. **Cash Balance Plans for Small Businesses**

1. **General Description.** A cash balance plan is a defined benefit plan that describes the participant's benefit as a notional account balance. Each year, a participant will receive a credit to his account, typically based on compensation. The account will also be credited with interest based on a pre-set benchmark. Most cash balance plans pay out the benefit in a lump sum, but this is not required.

2. **Contribution Limits.** Cash balance plans are subject to the benefit limit under Code section 415(b). Currently, the Code section 415(b) limit is \$195,000 annually as a straight life annuity. This limit will allow large contributions for older participants. For example, the contribution for a 30-year-old could be as much as \$43,000, and the contribution for a 60-year-old could be \$209,000. This limit is separate from the annual contribution limit that applies to defined contribution plans under Code section 415(c), currently, \$49,000.

3. **Interest Credits.** The participant's account must be credited each year with a defined rate of return. The most common rate used is the 30-year Treasury rate but other rates are acceptable, such as the 10-year or 1-year Treasury. The Pension Protection Act ("PPA") now allows cash balance plans to use one of various rates such as long-term corporate bond rates, or other market rates. "Market rates" have not been defined but proposed rules state that there must be a guarantee that the cumulative rate is not less than zero.

4. **Implementation Issues.**

a. *Significant contributions and deductions.* See Section III.A.3. above.

b. *Consistent profits.* A cash balance plan will require annual contributions, so consistent cash flow and profits are essential.

c. *Tax deferral.* The cash balance plan is a qualified retirement plan funded through a trust. Distributions from the cash balance plan can be rolled over to an individual retirement arrangement ("IRA") for additional tax deferral.

d. *Security.* Assets of the trust are exempt from the claims of creditors of both the plan sponsor and the participants.

e. *Minimum participation.* Cash balance plans are subject to the minimum participation rules of Code section 401(a)(26). Those rules require that a plan cover the lesser of (i) 50 employees or (ii) 40% of employees.

f. *Nondiscrimination.* The cash balance plan must satisfy the Code's nondiscrimination rules. This can be accomplished by giving every participant a "meaningful accrual" or by aggregating the plan with another plan that provides a benefit of 5% to 7.5% of compensation.

g. *Administrative complexity and cost.* The implementation and on going administration of a cash balance requires actuarial accounting and legal support. Pension Benefit Guaranty Corporation ("PBGC") premiums must be paid annually. The plan must be filed with the IRS for a determination letter as to its qualified status under the Code.

h. *Changing contribution levels.* Amendments to contribution levels cannot be made frequently.

i. *Investments.* Generally, the assets must be invested conservatively in order to match or come close to the interest crediting rate. This is particularly important for partnerships or companies that govern themselves like partnerships, because those businesses attribute each partner's cash balance contribution back to the partner as an overhead cost. Also, earnings and losses generally are amortized over a one-year period.

B. Conversion of Pre-Tax Contributions into Roth Contributions

1. Small Business Jobs Act of 2010 ("SBJA"). President Obama signed the SBJA into law on September 27, 2010. One provision of SBJA permits the conversion of pre-tax deferrals made under Code section 401(k), 403(b), 457(b) (as of January 1, 2011) and other pre-tax amounts to Roth contribution accounts.

2. Requirements. To allow the Roth conversion opportunity, the plan must include a Roth contribution arrangement, the converted amount must be distributable under the plan, and the distribution must be an eligible rollover distribution. The Roth contribution arrangement cannot be established solely to accept Roth conversions.

3. Distributable Events. Distributions may be made under Code section 401(k) upon separation from service, attainment of age 59½, death, disability, or hardship (and other events not applicable in this context). Hardship distributions may not be converted.

Other types of contributions, such as matching or nonelective or rollover contributions could be distributed as an in-service distribution if permitted under the plan. The plan's in-service distribution options can be expanded but can also be limited solely to Roth conversions. From a practical standpoint, only participants who are over 59½ or terminated participants will be able to convert pre-tax elective deferrals. If the plan already has an in-service distribution feature

for other types of contributions, such as rollover, matching or nonelective contributions, or if such a feature were added, those amounts can be converted. Note, however, that matching and nonelective contributions would have to satisfy either the two-year rule (amounts have been in the plan for two years) or the five-year-of-participation rule (the participant has earned at least five years of participation).

4. Taxation. Participants who convert will be taxed on the amount converted but will not be subject to the 10% additional tax under Code section 72(t) for early withdrawals.

C. 2010 Bonuses

1. Increase or Accelerate into 2010. Employees may opt to pay an additional or larger-than-normal bonus before year-end, or opt to pay in 2010 a bonus that otherwise would be paid in early 2011. Payment in 2010 could benefit the executive if income tax rates increase in 2011 due to expiration of tax cuts enacted in 2001 and 2003.

2. Balance with the Purpose of the Compensation. If acceleration would effectively eliminate a continued employment requirement or other vesting condition, an employer should weigh the importance of the condition against the potential for tax savings. More information as to the direction Congress will take should be available as December 31 approaches. For non-discretionary bonuses, therefore, it may make sense to accelerate only if it is clear that the top marginal rate(s) will increase for 2011.

D. Deferral Plans

1. Defer Income into Future Years. An executive may benefit from the ability to defer income into future years or spread payment of a large bonus over a number of years. This may be true for a particular executive even if marginal tax rates rise. Thus, an employer may implement an elective deferred compensation plan that can be used by executives on an annual basis.

2. Significant Features of a Deferral Plan. Deferred compensation plans for executives are not tax-qualified under the Code. Therefore, the deferred income is not held in trust but is payable from the employer's general assets. Associated risks are potential nonpayment (due to financial downturn) and change in ownership of the company. The latter concern is typically addressed through contractual provisions requiring a successor to assume the obligations, by operation of law, or – depending on the size of the unpaid obligations – through a rabbi trust funded on a change in control of the company.

3. 409A and Elective Deferrals. 409A now governs deferred compensation, which includes elective deferral plans and many other types of pay. 409A applies both to privately-held and public employers and is not limited to executive-level employees. Heavy tax penalties are imposed on the affected employee even though the employee often has little control over the design or operation of the pay arrangement. 409A addresses the time and form of payment of deferred compensation, changes to timing and form of payment, deferral elections, and other aspects of this type of pay. 409A also requires deferred compensation arrangements to be put in writing. Key aspects of 409A rules for elective deferred compensation are:

- a. With limited exceptions, salary must be deferred by December 31 of the year before the calendar year in which the salary is earned.
- b. With limited exceptions, a bonus must be deferred by December 31 of the year before the year in which the bonus begins to be earned.
- c. Special rules apply for fiscal year compensation, which, in some cases, may be deferred before the beginning of the fiscal year in which the compensation is earned.
- d. Elections must be irrevocable by the plan's terms before the applicable election deadline.
- e. In general, dates selected for the deferred payout cannot be further deferred unless the change defers the payment date for five years and is made one year before the scheduled payment date.
- f. Accelerations are generally prohibited. Exceptions to this rule are varied and include, for example: (i) provisions that accelerate payment on death, disability or change of control; (ii) satisfaction of a domestic relations order; (iii) certain hardships; and (iv) certain settlements over disputed awards.

4. 409A and Funding Devices. Funding of nonqualified deferred compensation is nearly always structured so that the funding arrangement does not trigger early taxation. One means of such funding historically has been a rabbi trust – the assets of which are subject to the claims of the employer's general creditors. Certain aspects of rabbi trusts are now subject to 409A.

- a. Rabbi trusts may call for trust assets to be brought current with deferred promises on an annual basis or, more commonly, to be funded on a change in control of the employer and periodically thereafter.
- b. 409A rules relating to funding of deferred compensation arrangements through a rabbi trust or otherwise include:

- i. The plan or related trust document cannot call for assets to be restricted to benefits in connection with a change in the employer's financial health.
- ii. Assets cannot be set aside, even if no plan or trust language requires the set aside.
- iii. Assets in a trust or other arrangement for the purposes of paying plan benefits cannot be located or subsequently transferred outside of the United States – e.g., in an offshore trust.
- iv. Assets cannot be set aside for payment of benefits under the nonqualified plan during a “restricted period” (a 409A-defined period of financial difficulty or risk) with respect to the employer's tax-qualified defined benefit plan.
- v. If the above funding rules are violated, the executive is subject to immediate taxation of the deferred benefits, penalties and interest.

E. Performance-Based Pay

1. Strategic Advantages. Performance-based pay offers a number of advantages for employers and executives. From the perspective of an individual who has already demonstrated the leadership skills needed to achieve executive-level status, job satisfaction should increase with the prospect of greater pay for attainment of positive results. For an employer, this type of compensation requires goal-setting. In creating a framework to reward performance, an organization's leaders may focus on market-based benchmarks, internal priorities, or customer preferences. An executive's interests are aligned with employer objectives under a properly designed incentive compensation program.
2. Tax-Related Advantages. Performance-based pay receives special treatment in some contexts under the Code. Sections III.E.3 and 4., below describe how incentive pay has preferred status for tax compliance purposes under 409A and deduction purposes under Code section 162(m) (“162(m”).
3. Types of Performance-Based Pay. Both equity compensation and cash compensation can qualify as performance-based for purposes of the tax rules discussed below.

- a. Performance-based equity compensation includes the following:
 - i. stock options;

- ii. stock grants;
- iii. performance-based vesting of stock grants;
- iv. phantom equity;
- v. performance-based earn-out of phantom shares; and
- vi. non-stock variations of the foregoing for partnerships and LLCs.

b. Performance-based cash compensation in the form of bonuses is one of the most common forms of incentive pay.

i. A performance period can be set by the organization, consistent with the objective sought. Monthly performance periods may work best for some targets; annual or multi-year periods may be appropriate for others. Short- and long-term incentives may be used simultaneously.

ii. Some of the tax rules described below require performance periods of at least one year, but shorter incentive periods may nonetheless be a valuable part of an organization's overall pay strategy.

4. Exemption from 409A. Some types of performance-based pay are not treated as "deferred compensation" under 409A. This is often the best result, because the compensation will be exempt from compliance with strict rules. Categories of performance-based pay exempt from 409A include the following:

a. A stock option granted with a current fair market value exercise price. 409A prescribes guidelines under which public and non-public companies may establish a compliant fair market value for this purpose. The guidelines are summarized below. Treasury Regulations section 1.409A-1(b)(5)(vi) should be consulted to ensure 409A compliance.

i. Public companies may value stock based on:

(A) the last sale before or the first sale after the grant;

(B) the closing price on the trading day before or the trading day of the grant;

(C) the arithmetic mean of the high and low prices on the trading day before or the trading day of the grant;

(D) any other reasonable method using actual transactions in such stock as reported by the established securities market on which the stock is traded; or

(E) an average selling price during a specified period within 30 days before or 30 days after the applicable valuation date, if certain requirements are met.

ii. Private companies may determine fair market value using a "reasonable application of a reasonable valuation method." Whether a valuation satisfies this standard is based on facts and circumstances as of the valuation date. Factors to be considered in setting value include:

(A) value of tangible and intangible assets of the company;

(B) present value of anticipated future cash flows;

(C) market value of stock or equity interests in similar companies engaged in substantially similar trades or businesses (if the value can be determined objectively);

(D) recent arm's-length transactions involving the stock;

(E) control premiums or discounts for lack of marketability;

(F) whether the valuation is used for other purposes that have a material economic effect on the company, its shareholders, or its creditors; and

(G) whether intervening events materially affect any prior valuation the company is seeking to rely upon, as all available information must be considered.

iii. Private companies may rely on one of several valuation safe harbors described in Treasury Regulations section 1.409A-1(b)(5)(iv)(B)(2), although the IRS may rebut the presumption if either the valuation method or its application is grossly unreasonable.

b. Stock awards subject to Code section 83 are also exempt from 409A, provided that the executive does not attempt to defer income inclusion prior to vesting. Exempt stock awards are actual grants of

restricted stock – as opposed to phantom shares, stock units, or similar awards that pay out based on stock value but do not constitute “a transfer of property” at the time the award is granted or promised.

c. Incentive or bonus programs where payment occurs within a short time following vesting or earn-out of the award – a “short-term deferral” – is another important category of exempt compensation

i. Payment must occur, *i.e.*, by the 15th day of the third month following the end of the (later of) the employer’s or executive’s taxable year in which vesting occurs.

ii. Although short-term deferrals exempt from 409A are not subject to the “written plan” requirement for deferred compensation, an employer still may wish to put in writing incentive plans that would constitute short-term deferrals. Doing so potentially allows the employer to comply with 409A where the exemption is lost because payment in a given year occurs after the 15th-day-of-the-third-month time frame described above.

5. More Lenient Deferral Deadline under 409A. Performance-based pay has an important exception to the election deadlines applicable to deferral plans discussed in Part II.D.3, above.

a. Deferrals of performance-based pay may be made as late as six months prior to the end of the performance period, as long as the election is made before the compensation is substantially certain to be paid.

b. This later deadline can be applied to pay subject to a performance period of at least 12 months. For a multi-year performance cycle, the later deadline would fall well into the cycle, allowing executives greater flexibility in planning whether and how much to defer.

c. Compensation may be “performance-based” for this purpose even if based on subjective performance criteria.

i. The subjective criteria must be *bona fide* and relate to the performance of the employee, a group of individuals including the employee, or a business unit (including the entire employer organization) for which the employee provides services.

ii. Whether subjective performance goals have been met cannot be determined by the employee, a relative of the employee, or a person under the employee’s or a relative’s control.

d. To use the special election timing rule, performance criteria must be set forth in writing not later than 90 days after the beginning of the performance period.

i. Compensation committee or shareholder approval of the criteria is *not* required for this purpose.

ii. Performance-based compensation must be contingent on attainment of the goals – *i.e.*, it cannot be payable whether or not the goals are met, except in the case of death, 409A-defined disability, or 409A-defined change of control.

iii. An executive must perform services continually from the later of the beginning of the performance period or the date the performance criteria are set through the date the election is made.

6. 409A Applies to Non-Executive Employees. Although an employer may focus on its executive group when using performance-based pay or other strategies described in this outline, it is important to remember that 409A's reach is not limited to executive-level employees. Therefore, to the extent other employees receive deferred compensation as defined under 409A, the planning considerations discussed above may be useful for that group, as well.

7. Exclusion from \$1 Million Deduction Cap Under 162(m). 162(m) limits the deduction for pay to top executives of public companies to \$1 million per year. Performance-based pay is excluded when calculating pay for purposes of the 162(m) limit. Special rules apply to employers participating in the Troubled Asset Relief Program ("TARP") under the Emergency Economic Stabilization Act of 2008, and performance-based pay is not excluded when applying the separate deduction limits for TARP recipients.

8. Categories of Performance-Based Pay for Purposes of 162(m). Various types of pay can qualify as performance-based if shareholder approval and other requirements are met.

a. Stock options granted with a current fair market value exercise price can qualify as performance-based pay. The company's stock plan must contain stated per-individual limits on option grants and meet shareholder approval and certain other requirements. The stated limit requirement can be accomplished easily with advance planning by the employer. Special rules apply to cancellations and repricings of options.

b. Stock grants that vest on attainment of performance goals and cash-based compensation can also be performance-based for 162(m) purposes with proper plan design and grant procedures.

i. Performance metrics, *e.g.*, return on equity, market share, stock price, etc.; maximum annual grant levels; and the class of eligible employees need to be pre-determined and approved by shareholders in advance of payment. Often, the metrics, grant levels and eligibility are included in a shareholder-approved incentive plan.

ii. Specific levels of attainment for a particular executive can be set year-by-year outside of the plan.

iii. Performance can be measured as improvement or even as maintenance of the status quo – for the executive, a business unit, or the organization as a whole. The compensation payable under the award must be objectively determinable (so that a third party could calculate the payment), although discretion to adjust the payment *downward* is permissible.

iv. Award terms must be determined, and satisfaction of criteria must be certified, by a compensation committee of the employer's board of directors that satisfies the requirements for independence under 162(m).

v. Goals for a particular executive must be established in writing no more than 90 days after the start of the performance period (or, if sooner, before more than 25% of the performance period has elapsed). The outcome of the performance goal must be substantially uncertain at the time the committee establishes the goal.

vi. With limited exceptions, compensation is not performance-based if it may be paid whether or not goals are met, *e.g.*, where vesting occurs or payment will be made upon retirement prior to the end of the performance period.

9. Periodic Reapproval by Shareholders. Where performance-based pay is granted under a plan that includes the metrics, maximum grant levels, and eligibility requirements – but that allows the compensation committee to set and change performance targets, *e.g.*, 5% annual increase in share price – periodic reapproval by shareholders is required.

a. Material terms of the plan, including the performance metrics, etc., must be disclosed to and reapproved by shareholders no later than the first shareholder meeting in the fifth year after the year in which the shareholders previously approved the plan. Thus, a plan that originally was approved in 2006 must be submitted to shareholders for reapproval no later than the first shareholder meeting in 2011.

b. Mid-five-year cycle changes to approved metrics, the eligible class of employees, or maximum grant levels must also be approved before payment under the changed elements, in order for the payment to qualify as performance-based under 162(m).

c. Although 162(m) requires shareholder approval as described above, employers should ensure that any additional and more frequent securities disclosure obligations are satisfied.

d. Financial accounting consequences should also be factored into any incentive compensation strategy.

F. Phantom Equity Payable on Permissible Events or Schedule

1. 409A. A phantom equity plan can be designed as a deferred compensation plan subject to 409A. 409A limits payment events to separation from service, death, disability, hardship, change in control, or on a fixed payment schedule. With the exception of death (because we all know what that is) all the permissible events must comply with the requisite 409A definition. However, as long as the plan's terms and its operation satisfy these rules, a participant will not be taxed until payment.

2. Design Alternatives. There are a myriad of design alternatives. Typically, the phantom equity plan will credit the participant's account with hypothetical shares of stock or LLC units. The credit can be made annually, periodically, or as a single award.

a. Vesting can be immediate or gradual. The plan can also be designed to vest credits to the account on a "class year" basis, where each credit will vest separately. This approach is similar to vesting in stock options or restricted stock awards.

b. Most phantom equity plans pay out in cash. The plan could contain an equity conversion feature on certain events such as a change in control.

G. Restricted Stock

1. Definition. Restricted stock refers to the award of stock to an employee in connection with the performance of services. Typically, the award is subject to a substantial risk of forfeiture (vesting) that does not lapse until a certain period of employment or the attainment of pre-established performance goals. Most restricted stock awards do not require the employee to pay anything for the stock.

The vesting schedule on the restricted stock can serve as a "golden handcuff," and the future appreciation is seen as an incentive for performance.

2. Taxation of Restricted Stock. The taxation of restricted stock is governed by Code section 83. Under Code section 83, the value of the property transferred will be included in gross income on the earlier of the date on which the property is no longer subject to a substantial risk of forfeiture or the date on which the property becomes transferable. In almost all cases, the income inclusion will occur on vesting.

3. 83(b) Election. An employee can make an election to be taxed in the year the restricted stock is awarded. Thus, the employee is taxed at ordinary income rates on the shares' fair market value as of the date of award, rather than the date of vesting. When the stock is ultimately sold, the employee will be taxed at capital gains rates on the difference between the sales price and basis in the stock.

a. A section 83(b) election is advantageous when the value of the company is low and the employee believes that there will be significant future appreciation. It also could be advantageous if future tax rates will increase. On the other hand, an 83(b) election can be risky if the stock never vests or has a lower value on the vesting date.

b. An employee who wishes to make an 83(b) election must follow certain procedures. An election must be filed with the IRS within 30 days of the transfer of property. The election must state the date of transfer, the nature of restrictions on the stock, and the fair market value of the stock on the transfer date. A copy of the election must be given to the employer and attached to the employee's tax return. Applicable state income tax rules should be consulted in advance, so that any additional filing or other requirements can be satisfied.

4. Substantial Risk of Forfeiture. Substantial risk of forfeiture under Code section 83 means "future performance of substantial services" or "occurrence of a condition related to the purpose of the transfer." Thus, in addition to time-based vesting, performance conditions can qualify as a substantial risk of forfeiture. The use of a non-compete agreement generally will not delay vesting under Code section 83 (although it is a facts and circumstances test).

5. Fair Market Value and Nonlapse Restrictions. Where an award of stock is granted with a "non-lapse" restriction attached, the effect can depress the current value, but allows for appreciation to be realized.

a. For example, if the stock granted were worth \$10 per share, stock awards could be granted with a restriction whereby the stock could never be sold, pledged, or otherwise disposed of without first offering the stock to the employer at its then-fair market value minus \$10. This right of first

refusal would continue to apply to the stock even if were transferred or sold to another party. Other vesting restrictions could attach to the employee's award, as well: *e.g.*, no ability to sell (to a third party or the company) for at least 3 years, or until a change of control.

b. The effect would be to make the value of the stock zero on the date of grant. The employee could make a Code section 83(b) election, as discussed above. The income recognized would be zero. If the stock eventually went to \$20, the executive could sell it – a willing buyer presumably would pay \$10 – and realize \$10 in appreciation.

H. Change in Control Agreements

1. Revisiting Change in Control Agreements. Change in Control (“CIC”) agreements can help to provide executives and employers with assurance that business operations can continue at an optimal level before and after a CIC, and that key decisions regarding a potential CIC can be made with shareholder interests in mind. Many companies are revisiting the level and types of CIC benefits in recent years to determine whether the package as a whole is appropriate in light of a more challenging economic climate, and – for public companies – focus from institutional shareholder advisory groups, and corporate reform legislation, such as “say on pay.”

a. The Dodd-Frank Act requires companies to implement say on pay for shareholder meetings after January 21, 2011.

b. RiskMetrics’ February 2010 Proxy Voting Guidelines Summary identifies a number of pay practices that RiskMetrics considers “problematic” or that may warrant an “against” vote on management say on pay proposals. Some of these practices relating to CIC compensation include:

- i. CIC payments in excess of three times salary and target bonus;
- ii. Single trigger CIC payments;
- iii. Excise tax gross-ups and tax reimbursements; and
- iv. More generally, although this stance could impact CIC practices, poor disclosure practices and lack of responsiveness to investor input on executive pay issues.

2. Findings – Large Public Companies. Research published by Frederic W. Cook & Co., Inc. (“Evolution of Change-in Control Practices: 2007 vs. 2010, August 20, 2010), finds the following trends among the 100 largest companies in the S&P 500 (by market capitalization) as of February 2010.

a. Three-times salary and bonus multiplier has trended down for both CEOs and CFOs from 2007 to 2010, with two times salary and bonus being the most prevalent CFO multiplier in 2010.

b. Equity vesting requiring a double trigger (CIC plus job loss) has trended up since 2007, although a single trigger still remains somewhat more prevalent.

c. Full gross-up of excise taxes imposed under Code section 4999 has declined significantly since 2007, while the trend is up for no gross-up. No gross-up was the prevailing practice in 2007 and 2010 for the companies studied.

3. Basic Tax Consequences for CIC Compensation. The golden parachute rules subject executives and certain other employees of C Corporations to a 20% excise tax on CIC compensation in excess of one times a prescribed “base amount” – if total CIC compensation considered for this purpose equals or exceeds *three times the base amount*. Employers face a loss of deduction under Code section 280G on amounts subject to the excise tax.

4. Basic Tax Strategies. While burdensome, these excise taxes have been addressed by companies in various ways. One strategy is to cap – cutting back if needed – relevant CIC compensation so that it falls beneath the three-times-base-amount level. The other end of the spectrum is a full tax gross-up, under which the employer agrees to make the executive whole for excise taxes incurred. A gross-up would be calculated so that additional income and excise taxes resulting from payment of the initial 20% tax also become the employer’s responsibility. Other variations on excise tax reimbursement promises are sometimes used.

5. Payout Trends Can Affect Tax Strategy. In addition to the expense and less favored view among institutional shareholders of full gross-ups, a fundamental consideration is whether the gross-up is likely to be relevant to a given pay package. To the extent economic challenges or shareholder views result in a strategic reduction in the levels of CIC compensation promised, a full gross-up may become less of an issue. In other words, if an employer determines that new or renegotiated contracts will provide CIC compensation below the three-times base amount level, in theory no gross-up would be needed to make the executive whole. Careful planning is required before any change in strategy, however.

a. CIC compensation can result from accelerated vesting of equity compensation, nonqualified pension vesting or enhancements (in many cases, whether or not double-trigger vesting is required), and other amounts besides straight cash severance.

b. The level of overage generally determines whether a participant is better off with a cap or with uncapped pay and responsibility to pay his or her excise taxes.

6. Exemptions, including by Shareholder Approval. Exemptions from the golden parachute rules apply to S corporations and corporations that could qualify as an S Corporation, without regard to the requirement that no nonresident alien be a shareholder, if an election were made. There is also an exemption in Code section 280G(b)(5) for C Corporations, where shareholders approve the CIC compensation in accordance with applicable requirements.

I. Executive Physicals

1. Tax-Free Reimbursements. An employer may offer executives tax-free reimbursement of the costs of "medical diagnostic procedures." The Code generally taxes discriminatory health benefits provided to highly compensated individuals. Reimbursements paid under a self-insured plan for "medical diagnostic procedures", however, are not subject to the nondiscrimination requirement.

2. Definitions. The term "medical diagnostic procedures" is defined to include routine medical examinations, blood tests, and X-rays. Procedures performed for the treatment, cure or testing of a known illness or disability, or treatment or testing for a physical injury, complaint or specific symptom of a bodily malfunction are not "medical diagnostic procedures." Additionally, "medical diagnostic procedures" do not include any activity undertaken for exercise, fitness, nutrition, recreation or the general improvement of health unless they are for medical care and deductible as medical expenses. The diagnostic procedures must be performed at a facility that provides no services (directly or indirectly) other than medical and ancillary services.

J. Executive Perquisites

1. Types of Perquisites. Many employers historically have offered a variety of perquisites to their executives. Examples include:

- a. reimbursement of club dues;
- b. automobile allowances;
- c. employer-provided automobiles;

- d. tax and financial planning services;
- e. reimbursement of spousal travel expenses;
- f. tax gross-ups on term life insurance; and
- g. tax gross-ups on other perks.

2. Trends. Trends in corporate governance standards and increased shareholder scrutiny of executive pay have begun to affect the level and types of perks offered. See, "Perks Are Trimmed Amid Pushback on Pay," WSJ.com, April 1, 2010, citing tax gross-ups for employer-provided benefits as one of the most commonly eliminated executive perks. While many companies have made targeted reductions or have reassessed the types and level of benefits offered, however, this traditional area of executive pay has not been eliminated.

3. 409A Impact on Perks. As noted above, 409A governs a broad array of pay arrangements in addition to nominal deferred compensation plans. Even provision of in-kind benefits or reimbursement arrangements with employees, including executives, may be covered. These arrangements are covered where there is a legally binding promise made in one year to provide a benefit or reimbursement that could become payable in a future year. The main issue here is whether the "deferred compensation" – *i.e.*, the benefit or reimbursement – is paid at a time or on an event permitted by 409A.

a. 409A allows deferred compensation payments to be made on a fixed date or fixed schedule. In the context of an elective deferral plan, for example, this means that the plan or employee election may comply with 409A by specifying (among other permissible payout schedules or events) that an account will be paid on a given date or on a given, definitive schedule of dates.

b. Satisfaction of a promise to provide in-kind benefits or reimbursements, by its nature, does not usually fall neatly into a fixed schedule. Promises often appear in an employment agreement, as an informal practice, or a written program applicable to certain executives. Because the promises could guarantee the provision of benefits in a future year, as long as expenses are actually incurred or the executive remains in a given position, the program must comply with 409A.

c. Treasury Regulations under 409A offer a method whereby in-kind benefits and reimbursement arrangements qualify as being payable on a "specified date" or "fixed schedule." Treasury Regulation section 1.409A-3(i)(1)(iv)(iv). This guidance is very useful for a wide range of executive perks and typically can be implemented without adding

significant verbiage to existing programs. Requirements for specified date/fixed schedule status are:

(i) A written plan or agreement must be used, although it need not be a complicated document.

(ii) The plan (including an employment or other individual agreement) must provide an objectively determinable nondiscretionary definition of the expenses eligible for reimbursement.

(iii) The plan (or agreement) must provide for the reimbursement or provision of benefits during an objectively and specifically provided period (including the lifetime of the executive).

(iv) The plan (or agreement) must provide that the amount of expenses eligible for reimbursement or in-kind benefits provided during the executive's taxable year may not affect the expenses eligible for reimbursement or in-kind benefits to be provided in any other taxable year.

A. This requirement affects plans that provide for a dollar cap on amounts that may that be reimbursed.

B. An executive who does not use the maximum allowable reimbursement under a plan or agreement in one year *may not* carry the balance over and add it to the following year's cap.

(v) Reimbursement must be made on or before the last day of the executive's taxable year following the taxable year in which the expense was incurred.

(vi) The right to reimbursement or in-kind benefits is not subject to liquidation or exchange for another benefit.

(vii) A plan providing a tax gross-up must provide that payment will be made – and the payment must in fact be made – by the end of the executive's taxable year following the taxable year in which the executive remits the related taxes.

THIS PAGE INTENTIONALLY LEFT BLANK