Nonqualified Deferred Compensation Plans and Equity-Based Compensation

Louis A. Mezzullo
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AND EQUITY-BASED COMPENSATION

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(October 8, 1997)
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## TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. INTRODUCTION TO NONQUALIFIED DEFERRED COMPENSATION PLANS</td>
<td></td>
</tr>
<tr>
<td>A. Definitions</td>
<td>1</td>
</tr>
<tr>
<td>B. Reasons for Using NDC Plans</td>
<td>2</td>
</tr>
<tr>
<td>C. Types of NDC Plans</td>
<td>3</td>
</tr>
<tr>
<td>D. Goals</td>
<td>4</td>
</tr>
<tr>
<td>II. TAX CONSIDERATIONS</td>
<td>5</td>
</tr>
<tr>
<td>A. In General</td>
<td>5</td>
</tr>
<tr>
<td>B. Constructive Receipt</td>
<td>5</td>
</tr>
<tr>
<td>C. Economic Benefit</td>
<td>9</td>
</tr>
<tr>
<td>D. I.R.C. § 83</td>
<td>9</td>
</tr>
<tr>
<td>E. I.R.C. § 402(b)(1)</td>
<td>10</td>
</tr>
<tr>
<td>F. Reasonable Compensation</td>
<td>10</td>
</tr>
<tr>
<td>III. RABBI TRUSTS AND SURETY BONDS</td>
<td>10</td>
</tr>
<tr>
<td>A. Definition</td>
<td>10</td>
</tr>
<tr>
<td>B. Reasons for Using Rabbi Trusts</td>
<td>11</td>
</tr>
<tr>
<td>Section</td>
<td>Page</td>
</tr>
<tr>
<td>------------------------------------------------------------------------</td>
<td>------</td>
</tr>
<tr>
<td>C. Tax Treatment</td>
<td>11</td>
</tr>
<tr>
<td>D. Surety Bonds and Other Third-Party Guarantees</td>
<td>13</td>
</tr>
<tr>
<td>IV. SECULAR TRUSTS</td>
<td>14</td>
</tr>
<tr>
<td>A. Definition</td>
<td>14</td>
</tr>
<tr>
<td>B. Reasons for Using Secular Trusts</td>
<td>14</td>
</tr>
<tr>
<td>C. Tax Treatment</td>
<td>14</td>
</tr>
<tr>
<td>V. ERISA</td>
<td>18</td>
</tr>
<tr>
<td>A. Coverage</td>
<td>18</td>
</tr>
<tr>
<td>B. Labor Department's Position on Rabbi Trusts</td>
<td>19</td>
</tr>
<tr>
<td>VI. EQUITY AND EQUITY-BASED COMPENSATION</td>
<td>19</td>
</tr>
<tr>
<td>A. Introduction</td>
<td>19</td>
</tr>
<tr>
<td>B. Incentive Stock Option (ISO) Plans</td>
<td>20</td>
</tr>
<tr>
<td>C. Nonqualified Stock Options (NSOs)</td>
<td>26</td>
</tr>
<tr>
<td>D. Stock Appreciation Rights and Reload Options</td>
<td>28</td>
</tr>
<tr>
<td>E. Restricted Stock</td>
<td>30</td>
</tr>
<tr>
<td>F. Junior Stock</td>
<td>34</td>
</tr>
<tr>
<td>G. Phantom Stock</td>
<td>35</td>
</tr>
<tr>
<td>VII. GIFTS OF STOCK OPTIONS: TRANSFER TAX CONSEQUENCES</td>
<td>36</td>
</tr>
<tr>
<td>A. Introduction</td>
<td>36</td>
</tr>
<tr>
<td>B. Transfer Tax Consequences</td>
<td>37</td>
</tr>
<tr>
<td>C. Income Tax Consequences</td>
<td>44</td>
</tr>
</tbody>
</table>
I. INTRODUCTION TO NONQUALIFIED DEFERRED COMPENSATION PLANS

A. Definitions.

1. The term "nonqualified deferred compensation plan" (NDC plan) will refer in this outline to any plan or arrangement providing for the payment of income to an employee (or an independent contractor in some cases) of a taxable entity after the year in which the individual enters into the arrangement or otherwise becomes a participant in the plan or arrangement and performs services, regardless of whether the plan or arrangement involves a voluntary decision by the individual to defer the receipt of the income. This outline does not cover the additional rules applicable to deferred compensation plans of state and local governments and tax-exempt organizations.

2. A Supplemental Executive Retirement Plan (SERP) is an NDC plan designed to supplement the retirement income that an executive receives from qualified retirement plans (plans qualified under Internal Revenue Code (I.R.C.) § 401(a)).

   a. A SERP that is designed solely to provide benefits in excess of those permitted in a qualified retirement plan because of the I.R.C. § 415 limitations is called an excess benefit plan under the Employee Retirement Income Security Act of 1974 (ERISA). See ERISA § 3(36).

3. A plan designed to benefit a select group of management and highly compensated employees is often referred to as a "top hat" plan.
B. Reasons for Using NDC Plans.

1. Reasons for Using SERPs.
   
   a. As mentioned, a SERP may be adopted to supplement a highly compensated employee’s pension under a qualified retirement plan when his or her benefit under the plan is capped because of I.R.C. § 415 limitations.

   b. A SERP may be used when the compensation cap under I.R.C. § 401(a)(17) ($160,000 in 1997 as a result of the Revenue Reconciliation Act of 1993 (RRA 93)) limits the annual benefit or annual addition that may be provided under a qualified retirement plan.

   c. An employer may adopt a SERP to provide benefits to highly compensated employees in amounts that would violate the nondiscrimination rules under I.R.C. § 401(a)(4) applicable to qualified retirement plans.
      
      (1) These rules prohibit benefits that disproportionately benefit highly compensated employees.

   d. A SERP permits highly compensated employees to defer additional compensation when they are limited by the actual deferral percentage test or the annual dollar limit on deferrals ($9,500 for 1997) under a 401(k) cash or deferred plan.

2. Other Reasons for Using NDC Plans.

   a. An NDC plan that is not subject to ERISA will not be required to provide a participant’s spouse with a qualified preretirement survivor annuity, a qualified joint and survivor annuity, or any other death benefits that would be required under a qualified retirement plan subject to the Retirement Equity Act of 1984.

   b. An NDC plan can provide benefits to independent contractors who cannot be covered under a qualified retirement plan.

   c. An NDC plan usually involves lower administration costs than qualified retirement plans.
d. NDC plans can also be used to encourage employees to retire early during an early retirement window program.

(1) Such programs are used when employers wish to reduce their labor force without layoffs.

(2) Usually employees over age 50 are given incentives to encourage them to retire voluntarily.

e. An NDC plan can be used to recruit a highly skilled employee by replacing the benefits that the employee may forfeit from the qualified or NDC plans of his or her former employer when transferring from one employer to another.

f. An employer can use an NDC plan as a golden handcuff to retain key employees.

(1) Under such a plan an employee would forfeit benefits if he or she terminated employment before a certain age.

g. An NDC plan can also be used to encourage performance by tying benefits under the plan to the achievement of certain employer earnings objectives.

h. An NDC plan can be used to provide key employees with some security against the possibility of a change in ownership or control that may result in their premature dismissal.

(1) Payments under these plans are often referred to as golden parachute payments.

C. Types of NDC Plans.

1. An NDC plan may be either employee motivated or employer motivated.

2. An employee-motivated plan usually involves a deferral of income that the employee would have been entitled to receive in any event and does not contain forfeiture provisions.

a. Such a plan usually takes on the characteristics of a defined contribution plan, such as a money purchase pension plan.
3. An employer-motivated plan usually involves an additional economic benefit provided by the employer to the employee and may contain vesting or forfeiture provisions.

   a. A SERP, including an excess benefit plan, is a typical example of this type of plan.

   b. An employer-motivated plan may often, but not always, take on the characteristics of a defined benefit plan.

D. Goals.

1. A nontax goal is to avoid all or most of the requirements of ERISA.

   a. Consequently, an NDC plan usually will be unfunded and will cover only management and highly compensated personnel.

2. From a tax standpoint, the goal most frequently is to defer recognition of income by the employee until the employee receives benefits under the plan.

   a. The downside to the corporation is the loss of an immediate deduction for compensation paid.

      (1) The corporation should be entitled to a deduction when the payments are includible in the employee’s gross income for federal income tax purposes.

3. While the amount of deferral is currently subject to Social Security and Medicare tax if there is no risk of forfeiture (which will usually be the case in an employee-motivated plan), most individuals covered by such plans will have current income subject to Social Security in excess of the Social Security wage base ($65,200 in 1997). But, as a result of RRA 93, the Medicare tax, 1.45 percent for both the employer and the employee, applies to all compensation income after 1993.

II. TAX CONSIDERATIONS

A. In General.

1. In the case of an employer-motivated arrangement containing a forfeiture provision, the employee should not be taxed on the economic benefit until there is no substantial risk that he or she will forfeit the benefit, regardless of whether the benefit is funded.

2. If there is no substantial risk that the employee will forfeit his or her benefit, the deferred income may be currently taxable to the employee under one of the following doctrines or Code provisions:

   a. The constructive receipt doctrine;
   b. The economic benefit doctrine;
   c. I.R.C. § 83, dealing with transfers of property for services; and
   d. I.R.C. § 402(b), dealing with the taxability of a beneficiary of a nonexempt trust.

B. Constructive Receipt.

1. Under the doctrine of constructive receipt, a taxpayer will be taxed on income that he or she is entitled to receive regardless of whether he or she actually reduces the income to his or her possession.

   a. The simplest example is interest credited to a bank account.


   a. The decision to defer must occur before the beginning of the period of service for which the compensation is payable, regardless of the existence in the plan of forfeiture provisions.

      (1) The period of service for purposes of this requirement generally is the calendar year for cash basis taxpayers.

      (2) There are two exceptions to this general requirement:
(a) In the year in which the plan is first implemented, the eligible participant may make an election to defer compensation for services to be performed subsequent to the election within 30 days after the date the plan is effective for eligible employees.

(b) In the first year in which the participant becomes eligible to participate in the plan, the newly eligible participant may make an election to defer compensation for services to be performed subsequent to the election within 30 days after the date the employee becomes eligible.

(3) If an employee may make additional elections to defer the payment of income after the beginning of the period of service, the payment must be subject to a substantial forfeiture provision.

(a) A substantial forfeiture provision must impose upon the employee a significant limitation or duty, the fulfillment of which will require a meaningful effort on the part of the employee, and there must be a definite possibility that the forfeiture could occur.

b. In addition, the plan must define the time and method for the payment of the deferred compensation for each event (such as termination of employment, regular retirement, disability retirement, or death) that entitles a participant to receive benefits.

(1) The plan may specify the date of payment or provide that payments will begin within 30 days after the occurrence of a stated event.

c. The plan may provide for the payment of benefits in the case of "an unforeseeable emergency."

(1) "Unforeseeable emergency" must be defined in the plan as an unanticipated emergency that is caused by an event beyond the control of the participant or beneficiary and that would result in severe financial hardship to the individual if early withdrawal were not permitted.
The plan must also provide that any early withdrawal approved by the employer is limited to the amount necessary to meet the emergency.

The plan may use language similar to that required under Treas. Reg. § 1.457-2(h)(4) and (5), dealing with NDC plans for employees of state and local governments and tax-exempt organizations.

d. The plan must provide that participants have the status of general unsecured creditors of the employer and that the plan constitutes a mere promise by the employer to make benefit payments in the future.

e. If the plan refers to a trust, the plan must also provide that any trust created by the employer and any assets held by the trust to assist it in meeting its obligation under the plan will conform to the terms of the model trust described in Rev. Proc. 92-64, 1992-2 C.B. 422.

(1) The employees’ rights to the trust assets cannot have any priority over the rights of unsecured creditors of the employer.

(2) The creditors’ rights provision in the trust must be enforceable under state law.

f. The plan must state that it is the intention of the parties that the arrangements be unfunded for tax purposes and for purposes of Title I of ERISA.

g. The plan must provide that a participant’s rights to benefit payments under the plan are not subject in any manner to anticipation, alienation, sale, transfer, assignment, pledge, encumbrance, attachment, or garnishment by creditors of the participant or the participant’s beneficiary.

3. The Internal Revenue Service will not issue rulings in connection with NDC plans for controlling shareholders. Rev. Proc. 94-3, I.R.B. 1994-1, Sec. 3.01(32).

4. The courts have been more liberal than the Service with respect to the application of the constructive receipt doctrine to NDC plans.
a. The decision to defer has been allowed after the services were rendered but before the amounts were determined. *James F. Oates*, 18 T.C. 570 (1952), aff'd 207 F.2d 711, 53-2 USTC ¶ 9596 (7th Cir. 1953). The Internal Revenue Service acquiesced in the case. 1960-1 C.B. 5.

b. The decision to defer has been allowed after the amount has been determined but before the employee was entitled to payment. *Howard Veit*, 8 T.C.M. 919 (1949). The Service has not acquiesced in this decision.

5. In *Martin v. Commissioner*, 96 T.C. 814 (1991), the tax court rejected the position of the Internal Revenue Service that two employees, who were participants in an unfunded NDC plan that was similar to a phantom stock plan, were in constructive receipt of the benefit under the plan because they were permitted to select between a lump sum distribution or installment payments before they terminated employment and became entitled to payment.

a. The basis of the holding was the fact that the elections were made before the amounts became due and ascertainable.

b. Despite the *Martin* case, the conservative approach would be to require the executive to select the method of payment at the time he or she commences participation.

   (1) If it is later determined that the executive desires to accelerate the payments or to receive a lump sum distribution of his or her entire benefit, the employer and the executive may amend the NDC plan.

   (a) In such a case, although the executive may receive his or her benefit in a lump sum and therefore not be concerned that the Internal Revenue Service would rule that the entire benefit becomes currently taxable, other participants in the same NDC plan or other NDC plans sponsored by the same employer who have not elected to receive a lump sum may be in jeopardy of having their deferred compensation currently taxable.

   (b) The Internal Revenue Service could take the position that the other participants in the NDC plans
were in constructive receipt of the contributions as they were made since there was an understanding that the participants and the employer were free to amend the plan at any time.

C. Economic Benefit.

1. The economic benefit doctrine could cause the employee to recognize the income even if there is no constructive receipt of the income.

2. Under this doctrine, an employee is taxed on money or other property set aside in a fashion that gives him or her an unrestricted, nonforfeitable right to receive the money or other property at some future date, even though he or she is not currently able to receive the money or other property. E. T. Sproull, 16 T.C. 244 (1951), aff'd 194 F.2d 541 (6th Cir. 1952).

3. A mere unsecured promise of the corporation to make a payment in the future does not result in giving an economic benefit to the employee.

4. The key factor preventing current recognition of income is the fact that the deferred income is subject to the creditors of the corporation.
   a. Naturally, this fact may be troubling to the employee who has deferred income that he or she would otherwise have received without the risk of losing the income as a result of the bankruptcy of the corporation.
   b. Also bothersome to the employee is the fact that he or she may have to enforce his or her right through lengthy and costly litigation.
   c. Consequently, employees have sought to protect their rights to the deferred income from the corporation's creditors or from a change of heart by the corporate management through various funding devices and by obtaining surety bonds protecting their contractual rights. See the discussion on "rabbi trusts" and "secular trusts" below.

D. I.R.C. § 83.

1. I.R.C. § 83 requires that the excess of the fair market value of any property transferred in connection with the performance of services over
any amount paid for such property be included in the income of the person performing such services when rights of the person having the beneficial interest in the property are either transferable or no longer subject to a substantial risk of forfeiture.

a. The mere promise of the corporation to make a payment in the future is not treated as property for this purpose. Treas. Reg. § 1.83-3(e).

E. I.R.C. § 402(b)(1).

1. I.R.C. § 402(b)(1) states that "Contributions to an employees' trust made by an employer during a taxable year of the employer which ends within or with a taxable year of the trust for which the trust is not exempt from tax under section 501(a) shall be included in the gross income of the employee in accordance with section 83 (relating to property transferred in connection with performance of services)...."

a. Therefore, if the deferred income arrangement is equivalent to an unsecured promise to pay money in the future, I.R.C. § 402(b)(1) should not apply.

F. Reasonable Compensation.

1. I.R.C. § 404(a)(5) allows the employer to deduct its contributions to NDC plans in the year that the contribution "is includible in the gross income of the employee."

2. Such payments are deductible only "if they would otherwise be deductible." I.R.C. § 404(a).

3. If current or deferred employee compensation is to be "otherwise deductible," it must not exceed an amount that "is reasonable under all the circumstances." Treas. Reg. § 1.162-7(b)(3).

III. RABBI TRUSTS AND SURETY BONDS

A. Definition.

1. A rabbi trust, so-named for the taxpayer involved in the first published letter ruling approving such an arrangement, is usually an irrevocable grantor-type trust.
2. Under a rabbi trust, the corporation will be taxed on the income of the trust and the trust will be subject to the corporation’s creditors. Rev. Proc. 92-64, I.R.B. 1992-33.

B. Reasons for Using Rabbi Trusts.

1. An employee may be concerned about having to enforce his or her right to the deferred income against the employer through lengthy and costly litigation if the employer later has a change of heart and refuses to comply with the agreement.

2. The employee may also be concerned about a takeover by another company that would refuse to comply with the agreement.

3. A rabbi trust, while it will not protect the employee in the event of a bankruptcy of the employer, will provide protection against a recalcitrant employer or a takeover.

C. Tax Treatment.

1. At least two issues are raised by the use of rabbi trusts.

   a. Can the assets in the trust be protected from certain creditors without having the economic benefit doctrine apply?

   b. Is the employer required to take any steps with respect to notifying the trustees of the trust in the event the corporation’s bankruptcy or insolvency is imminent?

2. After a period in the mid-1980’s when the Internal Revenue Service refused to issue private letter rulings in connection with rabbi trusts, the Service resumed issuing rulings in 1986. However, these rulings were premised on satisfaction of at least three conditions:

   a. The trust assets had to be available to all the general creditors of the employer if the employer filed for bankruptcy;

   b. Payments to the employee (presumably triggered by insolvency) when the employer’s net worth falls below a certain point were not permitted; and
c. A procedure to provide notice to the trustees in the event of the bankruptcy of the employer or financial hardship of the employer was required.

Statement by A. Thomas Brisendine, a rulings group chief in the Internal Revenue Service Chief Counsel’s office as reported in ¶ 25,770, CCH Pension Plan Guide; PLRs 8739052, 8739031, 8737091, 8727028, 8725036, and 8634031.

3. In Rev. Proc. 92-64, 1992-2 C.B. 422, the Internal Revenue Service provided a model trust intended to serve as a safe harbor for taxpayers that adopt and maintain grantor trusts in connection with unfunded NDC plans.

a. If the model trust is used in accordance with the revenue procedure, an employee will not be in constructive receipt of income or incur an economic benefit solely on account of the adoption or maintenance of the trust.

b. The Service will no longer issue rulings on unfunded NDC plans that use a trust other than the model trust except in rare and unusual circumstances.

c. The model language must be adopted verbatim except where substitute language is expressly permitted and additional language not inconsistent with the model language may be added.

d. The trust must be valid and its terms enforceable under state law.

e. The trustee must be an independent third party that may be granted corporate trustee powers under state law, such as a bank trust department.

(1) The trustee must be given some investment discretion, such as the authority to invest within broad guidelines established by the parties (e.g., invest in government securities, bonds with specific ratings, or stocks of Fortune 500 companies).

f. The model trust contains optional provisions, which may be replaced by language not inconsistent with the model trust language.
The model trust also contains several alternative provisions. The taxpayer must choose one of these alternatives.

(1) For example, the trust may by its terms be revocable by the company, irrevocable, or subject to becoming irrevocable after a change in the control of the company, after a favorable ruling from the Service, or upon approval of the plan by the board of directors.

(2) In addition, contributions may be discretionary at all times or may become mandatory after a change in control of the company or after a period of time.

D. Surety Bonds and Other Third-Party Guarantees.

1. The use of a surety or security bond is another method by which an employee can protect his or her rights under a deferred compensation arrangement.

a. PLR 8406012 (November 3, 1983) held that an employee received no current taxable income when the employee purchased a security bond from an independent insurance company to protect his or her deferred compensation. See also PLR 9344038 (August 2, 1993).

b. If the employer pays the premium on the surety bond, the premium will be treated as compensation to the employee, and the deferred income may also be currently taxed to the employee.

c. If the employee pays the premium, the employee may argue that the premium is deductible under I.R.C. § 212 as an expense incurred for the production of income. But see PLR 9344038 (August 2, 1993) denying a deduction under I.R.C. § 162.

d. Evidently the high cost of such premiums has discouraged the use of surety bonds as a way of protecting the employee’s rights.

2. The employee’s rights to the deferred compensation may be guaranteed by another party, such as a parent or other affiliate of the employer. See PLR 8906022 (November 10, 1988), holding that such a guarantee will not cause the employer’s promise to be treated as secured.
IV. SECULAR TRUSTS

A. Definition.

1. A secular trust is an irrevocable trust that is not subject to the creditors of the employer.

2. The employer makes contributions to the trust to fund an NDC plan for one or more employees.

3. Because the trust is funded, as that term is used in ERISA, the reporting, disclosure, vesting, fiduciary, and other requirements under Title I of ERISA must be satisfied, including the spousal rights requirements added by REA.

B. Reasons for Using Secular Trusts.

1. A secular trust avoids the problem of the potential insolvency of the employer.

2. An employer may use a secular trust as a golden handcuff, because the employer can impose a vesting schedule (as long as it satisfies the vesting requirements under ERISA).

3. The employer will receive an immediate deduction for contributions to the trust to the extent the employee is vested.

4. A secular trust may serve as forced saving for the employee.

C. Tax Treatment.

1. Because the employee’s benefit is not subject to the creditors of the employer, the employee is taxed when he or she is vested in the benefit, which may occur at the time the employer makes the contribution, or at a later date when the employee’s right to the benefit is no longer subject to a substantial risk of forfeiture. I.R.C. § 402(b)(1).

   a. In many NDC plans using a secular trust, the employer agrees to pay additional compensation to the employee equal to the tax on the amount of deferred compensation the employee must report as current income (including the additional compensation).
b. The employee obtains a tax basis in the benefit equal to the amount reported as taxable income.

2. If one of the reasons a trust is not exempt from tax under I.R.C. § 501(a) is the failure of the plan of which the trust is a part to meet the requirements of I.R.C. § 401(a)(26) or 410(b), the amount currently included in an employee’s income depends upon whether the employee is a highly compensated employee as defined in I.R.C. § 414(q). I.R.C. § 402(b)(4).

a. A highly compensated employee includes in gross income an amount equal to the vested accrued benefit of the employee (other than the employee’s basis in the benefit because of previous inclusions in taxable income).

(1) Consequently, a highly compensated employee who is fully vested in his or her benefit will always have a tax basis in his or her vested benefit equal to the value of his or her accrued benefit, except for the current year’s taxable income of the trust.

(2) In addition, a highly compensated employee will be taxed on the value of any earnings that increase the value of his or her benefit, even though the trust is also taxable on the same earnings.

(3) While the trust will not be subject to tax on unrecognized gain or the tax-free build-up in the cash value of life insurance contracts, the highly compensated employee will still be taxable on such gain or build-up in value, since the gain or build-up increases the value of his or her accrued benefit.

(4) A highly compensated employee is an employee who owns more than five percent of the employer during the year or preceding year or had compensation for the preceding year of $80,000 (indexed) and, if the employer elects, was in the top 20 percent of employees by compensation for such year. I.R.C. § 414(q).

b. A nonhighly compensated employee reports income equal to the value of the employer’s contribution when it becomes substantially vested under the principles of I.R.C. § 83. I.R.C. § 402(b)(1).
(1) Consequently, earnings and gains on the employer's contributions after they become vested generally will not be taxed currently to the employee.

c. Note that most, if not all, secular trusts used in connection with defined benefit type plans will fail to satisfy the requirements of I.R.C. § 401(a)(26), requiring that the plan benefit the lesser of (1) 50 employees of the employer or (2) the greater of 40 percent or more of all employees of the employer (now applicable only to defined benefit plans) or two employees (or if there is only one employee, one employee), and most, if not all, secular trusts used in connection with either type of plan will fail to satisfy the requirements of I.R.C. § 410(b), requiring that the plan benefit a percentage of nonhighly compensated employees which is at least 70 percent of the percentage of highly compensated employees benefiting under the plan.

d. It was initially thought that I.R.C. § 402(b)(4)(A) applied only to retirement plans that were intended to be qualified under I.R.C. § 401(a). The Internal Revenue Service now applies I.R.C. § 402(b)(4)(A) to plans that clearly were never intended to be qualified. See PLR 9417013.

3. The employer receives a deduction for amounts contributed to the plan when the employee must include the benefit in his or her gross income, but only if separate accounts are maintained for each participant in the plan. I.R.C. § 404(a)(5).

a. In PLRs 9206009 and 9207010, the Internal Revenue Service held that separate accounts did not exist when the income generated by the assets in the accounts was paid to the employer or was subject to allocation to the accounts of other participants in the plan.

4. The trust pays tax on any income generated by the assets in the trust to the extent the income is not distributed to the participant unless the employee is treated as the settlor of the trust, in which case the employee reports the income on his or her own return pursuant to the grantor trust rules.

a. In PLRs 9206009, 9207010, 9212019, and 9212024 the Internal Revenue Service held that the rules under I.R.C. §§ 402(b) and 404(a)(5) precluded a trust taxed under I.R.C. § 402(b) (referred to in the rulings as a "section 402(b) employees' trust") from being
treated as owned by the employer under the grantor trust rules, even though the employer was entitled to receive income generated by assets held in the accounts of participants who were not in pay status.

b. An employee will be treated as the grantor of the trust if the contributions of the employee are not incidental. Contributions made by the employee are not incidental if the employee's total contributions at any date exceed the employer's total contributions. Treas. Reg. § 1.402(b)-1(b)(6).

5. The Service in the same set of private letter rulings held that distributions from the trust would be taxed under I.R.C. § 72, which deals with the tax treatment of annuities. See also I.R.C. § 402(b)(2).

a. Under I.R.C. § 72(b), amounts received in the form of an annuity would be included in the recipient's taxable income to the extent they exceeded a pro rata portion of the employee's investment in the contract, which would be the amount the employee had previously taken into income.

b. Under I.R.C. § 72(e), amounts received before the annuity starting date would be included in gross income to the extent that the value of the employee's vested accrued benefit exceeded the employee's basis.

(1) Income of the trust distributed to the employee before the annuity starting date will be included in the employee's income and deductible to the trust. I.R.C. § 402(b)(2).

(2) A highly compensated employee generally should recognize income only to the extent of the current year's taxable income of the trust, since his or her basis in the trust should always be equal to the value of the assets in the trust at the end of the preceding year, at least to the extent he or she is vested.

(3) Under I.R.C. § 72(q), an employee under age 59½ may be subject to a ten-percent additional income tax on the taxable amount of a distribution.
V. ERISA

A. Coverage.

1. ERISA applies to all employee pension benefit plans, including plans that are not designed to qualify under I.R.C. § 401(a).

   a. An employee pension benefit plan is defined as any plan, fund, or program established or maintained by an employer or by an employee organization, or by both, to the extent that by its terms or as a result of surrounding circumstances such plan, fund, or program (1) provides retirement income to employees, or (2) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond, regardless of the method of calculating the contributions made to the plan, the method of calculating the benefits under the plan, or the method of distributing the benefits from the plan. ERISA § 3(2)(A).

2. ERISA exempts from most of its requirements unfunded plans for a select group of management or highly compensated employees. ERISA §§ 201 (participation and vesting), 301 (funding), 401 (fiduciary responsibility).

   a. Such "top hat plans" can satisfy the reporting and disclosure requirements of Part I of Title I by filing a statement with the Department of Labor that sets forth the name and address of the employer, the employer identification number, a declaration that the employer maintains one or more such plans, and the number of employees in each plan. Dept. of Labor Reg. § 2520.104-23.

3. ERISA exempts unfunded excess benefit plans from all the provisions of Title I. ERISA § 4(b)(4).

   a. An excess benefit plan is maintained solely for the purpose of providing benefits for certain employees in excess of the limitations on contributions and benefits imposed by I.R.C. § 415, whether or not funded.

   b. The Labor Department takes the position that the terms of the excess benefit plan and the qualified retirement plan that the excess benefit plan supplements must be exactly alike; if the NDC plan permits lump sum distributions and the qualified retirement plan does not, the NDC plan will not qualify as an excess benefit plan.
B. Labor Department’s Position on Rabbi Trusts.

1. The Labor Department, responding to a request from the Internal Revenue Service, has determined that top hat plans and excess benefit plans will not be treated as funded even though a "rabbi trust" is used by the employer in connection with such plans. Letter to Internal Revenue Service dated December 13, 1985.

2. On May 19, 1992, in Advisory Opinion 92-13A, the Labor Department reaffirmed its opinion that an excess benefit plan or top hat plan would not be treated as funded although a "rabbi trust" is used to pay the benefits.
   a. The employer’s contributions were to be invested in the corporation’s common stock.
   b. The opinion noted that the trust arrangements did not contain mandatory contribution provisions.

3. In Opinion Letter 91-16A, issued April 5, 1991, the Labor Department held that a model rabbi trust drafted by the Internal Revenue Service (an earlier draft of the model trust contained in Rev. Proc. 92-64) would not cause an excess benefit plan or top hat plan to be treated as funded.
   a. The model trust contained two alternative provisions that required mandatory contributions under certain conditions (as does the model trust in Rev. Proc. 92-64).

VI. EQUITY AND EQUITY-BASED COMPENSATION

A. Introduction.

1. Types of Plans.
   a. There are two types of executive stock option plans: incentive stock options (ISOs), which receive favorable tax treatment; and nonqualified stock options (NSOs).
   b. Restricted stock refers to stock subject to restrictions on transferability and to redemption by the corporation upon the occurrence of certain events, such as termination of employment.
c. In addition to stock options and restricted stock, other forms of equity and equity-based compensation have been developed, including junior stock and phantom stock.

2. Reasons for Using Equity and Equity-Based Compensation Plans.

a. In order to reward or retain key employees, corporate employers often grant to such employees options to purchase stock in the corporation or stock in the corporation that is restricted with respect to transferability and is subject to being redeemed at the behest of the corporation.

b. A growing company, unable to match the cash compensation larger companies can afford, may be able to attract highly qualified employees with offers of an equity interest.

c. Shareholders may view the ownership of the stock by management as a means of enhancing their performance and dedication to the company.

d. Stock ownership may protect executives financially should a takeover result in the termination of their employment.

B. Incentive Stock Option (ISO) Plans.

1. Tax Consequences.

a. To the employee.

(1) The employee does not recognize income at the time of the grant or the time of the exercise of the option. I.R.C. §§ 83(e)(1); 421(a)(1).

(2) The employee recognizes capital gain equal to the difference between the amount paid for the stock and the amount realized when the stock is sold as long as the stock has been held two years after the grant and one year after the exercise of the option. I.R.C. § 422(a).

(a) The Taxpayer Relief Act created a 20 percent capital gain rate for capital assets held for more than 18 months for sales after July 28, 1997.
(b) Presumably, if the stock purchased pursuant to the option is held for more than 18 months, the 20 percent rate will apply.

(c) The 20 percent rate is reduced to ten percent if the taxpayer is in the 15 percent bracket.

(d) If the stock is held for more than 12 months but not more than 18 months, gain will be taxed at 28 percent.

I.R.C. § 1(h), as amended by § 311(a) of the Taxpayer Relief Act of 1997.

(3) The difference between the amount paid under the option and the fair market value of the stock at the time the option is exercised is an adjustment in determining alternative minimum taxable income. I.R.C. § 56(b)(3).

(a) Beginning in 1993, the alternative minimum tax rate is 26 percent on the first $175,000 of alternative minimum taxable income ($87,500 for a married couple filing separate returns) in excess of the exemption ($45,000 for a married couple filing a joint return and $22,500 for a married couple filing separate returns) and 28 percent on the balance. The exemption is phased out, depending on the taxpayer's alternative minimum taxable income.

(b) The employee will receive an increase in basis in the stock for alternative minimum tax purposes equal to the amount included in alternative minimum taxable income. I.R.C. § 56(b)(3).

(4) If there is a premature disposition, the employee incurs ordinary income equal to the difference between the amount paid under the option and the fair market value at the time of the exercise of the option. I.R.C. § 421(b).

b. To the corporation.
(1) There is no deduction to the corporation either at the time of the grant of the option or at the time the option is exercised by the employee. I.R.C. § 421(a)(2).

(2) There is no deduction to the corporation at the time of the sale of the stock by the employee unless the employee sells the stock before the expiration of the required holding period. I.R.C. §§ 421(a) and 421(b).

(a) In such a case the corporation will be entitled to a deduction equal to the difference between the amount the employee paid for the option and the fair market value of the stock at the date of the exercise as long as the corporation reports the amount on the employee’s W-2 form.

2. Requirements.

a. Required provisions.

(1) The option must be granted under a plan specifying the aggregate number of shares of stock that may be issued and the employees or class of employees eligible to receive the option. I.R.C. § 422(b)(1).

(2) The plan must be approved by the shareholders of the granting corporation within 12 months before or after the plan is adopted. I.R.C. § 422(b)(1).

(3) The option must be granted within ten years from the earlier of (x) the date the plan is adopted or (y) the date the plan is approved by the shareholders. I.R.C. § 422(b)(2).

(4) The option must be exercisable only within ten years of the date it is granted. I.R.C. § 422(b)(3).

(5) The option price must equal or exceed the fair market value of the stock at the time the option is granted. I.R.C. § 422(b)(4).

(a) This requirement will be deemed satisfied if there has been a good faith attempt to value the stock.
accurately, even if the option price is less than the fair market value. I.R.C. § 422(c)(1).

(6) The option by its terms must be nontransferable other than at death and, during the employee’s lifetime, must not be exercisable by any other person. I.R.C. § 422(b)(5).

(7) ISOs may only be issued to employees. I.R.C. § 422(b).

(8) Generally, the employee must not, at the time the option is granted, own stock representing more than ten percent of the voting power of all classes of stock of the employer corporation or its parent or subsidiary. I.R.C. § 422(b)(6).

(a) If the option price is at least 110 percent of the fair market value of the stock subject to the option determined at the time the option is granted and the option by its terms is not exercisable more than five years from the date it is granted, the employee may own stock representing more than ten percent of the voting power of all classes of stock of the employer corporation or its parent or subsidiary. I.R.C. § 422(c)(5).

(9) The terms of the plan must limit to $100,000 the aggregate fair market value (determined at the time the option is granted) of the stock with respect to which ISOs are exercisable for the first time by an employee during any calendar year. I.R.C. § 422(d).

(a) Before the Tax Reform Act of 1986 (TRA ’86), the $100,000 limit applied to the aggregate fair market value of stock for which the employee could be granted options in any calendar year.

(10) Before TRA ’86, the option by its terms could not be exercisable while there was outstanding any ISO which was granted to the employee at an earlier time.

(a) Under this rule, an option that had not been exercised in full was treated as outstanding until the expiration of the period during which it could have been exercised in its initial term; furthermore, the
cancellation of an earlier option did not enable a subsequent option to be exercised any sooner.

(b) The repeal of the sequential exercise rule and the change in the limitation have made incentive stock options more favorable.

b. Permissible provisions.

(1) Shares of stock acquired on the exercise of an ISO may be paid for with stock of the corporation granting the option. I.R.C. § 422(c)(4)(A).

(2) The employee may have the right to receive additional compensation (in cash or other property) at the time of the exercise of the option so long as the additional amount is includible in income under the provisions of I.R.C. §§ 61 and 83. I.R.C. § 422(c)(4)(B).

(a) For example, the employer corporation may pay the employee amounts (whether or not the amount of additional compensation is determined by reference to the price of the stock and/or the option price) when the employee exercises the option.

(3) The option may be subject to a condition not inconsistent with the qualification requirements of I.R.C. § 422(b). I.R.C. § 422(c)(4)(C).

(a) For example, an employee’s right to receive a taxable payment of cash or other property (including employer stock) in an amount equal to the difference between the then fair market value and the option price in exchange for the cancellation or surrender of the option (at a time when it is otherwise exercisable) does not disqualify the option.

i) This applies where the exercise of this alternative right has the same economic and tax consequences as the exercise of the option followed by an immediate sale of the
stock to the employer (which would be taxed as ordinary income under I.R.C. § 421 (b)).

(b) However, an option that includes an alternative right is not an ISO if the requirements of I.R.C. § 422(b) may be avoided by exercising the alternative right.

i) For example, an alternative right extending the option term beyond ten years, setting a price below fair market value, permitting transferability, or allowing nonsequential exercise for options granted before 1987, will prevent an option from qualifying as an incentive stock option.

(4) The plan under which the ISO is issued may be one that allows issuance of both ISOs and nonqualified stock options.

c. Requirements for capital gain treatment.

(1) The individual must not dispose of the stock acquired pursuant to the exercise of an ISO within two years after the option is granted and must hold the stock itself for at least one year, subject to an exception for certain transfers by insolvent individuals. I.R.C. §§ 422(a)(1) and (c)(3).

(2) For the entire period from the date of the granting of the option until three months (one year if employment ceases because the individual is disabled) before the date of the exercise, the individual must be an employee either of the corporation granting the option, a parent or subsidiary of that corporation, or a corporation (or parent or subsidiary of that corporation) which has assumed the option of another corporation as a result of a corporate reorganization, liquidation, etc. I.R.C. § 422(a)(2), (c)(6).

(3) In the event of the death of an individual, both the holding period and employment requirements are waived. I.R.C. § 421(c)(1)(A).
The employee, upon a premature disposition, recognizes ordinary income equal to the difference between the option price and the lesser of (x) the fair market value of the stock at the time of the exercise or (y) the amount realized in the sale. I.R.C. § 421(b).

d. If the employer does not want an option treated as an ISO, but coincidentally the option satisfies the requirements of an ISO, the option should specifically state that the option is not an ISO; otherwise it will be treated as an ISO. I.R.C. § 422(b).

C. **Nonqualified Stock Options (NSOs).**

1. **Tax Consequences.**

a. To the employee.

(1) Generally the granting of the option will not be treated as a taxable event, as long as the option does not have an ascertainable fair market value. Regulations make it difficult to establish an ascertainable fair market value at grant. Treas. Reg. § 1.83-7(b).

(2) When the option is exercised, the employee will recognize ordinary income (treated as compensation income) equal to the difference between the option price and the fair market value of the stock at the time that the option is exercised. I.R.C. § 83(a).

(3) The employee will have a basis in the stock equal to the amount paid for the stock plus the amount of income recognized by the employee as a result of the exercise of the option.

(4) If the stock purchased is subject to a substantial risk of forfeiture and is not transferable, then the employee will not recognize income at the time the option is exercised but at the time that the stock becomes transferable or is no longer subject to a substantial risk of forfeiture, whichever occurs earlier. I.R.C. § 83(a).

b. To the corporation.
(1) The corporation may deduct the amount of compensation when it is included in the employee’s gross income as long as it reports the income on the employee’s W-2 form.

2. Comparison with ISOs.

a. Tax consequences.

(1) To the employee.

(a) The principal benefits of an ISO plan to an employee are (x) the ability to time the date when the employee will recognize taxable income equal to the difference between the option price and the fair market value of the stock at the time the option is exercised, and (y) capital gain treatment of such differential.

i) Having the gain treated as capital gain may be an advantage if the employee has capital losses.

ii) Long-term capital gains (if the holding period is more than 18 months) are taxed at a 20 percent rate after May 7, 1997.

iii) The employee should also consider the effect of the alternative minimum tax, which applies to an ISO but not to nonqualified stock options.

(2) To the corporation.

(a) The employer is not entitled to a deduction in connection with the exercise of an ISO unless the employee makes a disqualifying disposition.

(b) The employer is entitled to a deduction under an NSO at the same time the employee recognizes income, and therefore, from the corporation’s financial standpoint, an NSO is less expensive, since the corporation is able to offset income with the deduction, even though it is not making a cash
outlay to the employee, but instead is transferring stock.

b. Nontax advantages of an NSO over an ISO.

(1) If the employer wants to grant options to nonemployees, an ISO cannot be used.

(2) The option price under an ISO must be equal to the fair market value of the stock at the time the ISO is granted, whereas the option price under an NSO may be considerably less than the fair market value of the stock as long as the option price is not so low as to cause the option to be treated as a transfer of the stock subject to the option.

(3) An ISO must be granted within ten years of the earlier of (x) the adoption of the plan, or (y) the approval of the shareholders; and it must be exercised within ten years after the date of grant.

(a) No similar restriction applies to either the granting or the exercise of an NSO. An NSO may be freely transferable by the employee.

(4) An NSO does not have to be approved by the shareholders of the corporation unless required under nontax law, such as the state’s corporation law or securities laws.

(5) There is no tax law restriction on the amount of NSOs that may be granted or exercised at any given time.

D. Stock Appreciation Rights and Reload Options.

1. An employer may grant an employee a stock appreciation right (SAR) in connection with an option to purchase stock.

a. Under an SAR, an employee is entitled to receive cash or other property (usually stock of the employer) with a value equal to the difference between the fair market value of a share of stock at the time of the grant of the SAR and the fair market value of the share at the time the SAR is exercised.
b. Because the employee must forfeit his or her right to future appreciation when the SAR is exercised, the Internal Revenue Service has ruled that the employee does not recognize income until the employee exercises the right. Rev. Rul. 80-300, 1980-2 C.B. 165; Rev. Rul. 82-121, 1982-1 C.B. 79.

2. An SAR may be issued in tandem with an ISO, in an arrangement where both the ISO and the SAR are granted together and the exercise of one affects the right to exercise the other.

a. The SAR must, by its terms, meet the following requirements:

(1) The SAR will expire no later than the expiration of the underlying ISO;

(2) The SAR may be for no more than 100 percent of the spread, i.e., the difference between the exercise price of the underlying option and the market price of the stock subject to the underlying option at the time the SAR is exercised;

(3) The SAR is transferable only when the underlying ISO is transferable, and under the same circumstances;

(4) The SAR may be exercised only when the underlying ISO is eligible to be exercised; and

(5) The SAR may be exercised only when there is a positive spread, i.e., when the market price of the stock subject to the option exceeds the exercise price of the option.

b. The SAR may be paid either in cash or property, or a combination of both.

(1) If any property is received other than cash, I.R.C. § 83 applies to the property.

(a) Consequently, if the property is stock that is subject to a substantial risk of forfeiture, the employee recognizes no income until the restriction is removed or lapses.

3. An SAR issued in tandem with an NSO does not have to satisfy any particular requirements.
   a. However, the employee will recognize income when the SAR is exercised if the employee receives cash or nonrestricted stock, and will recognize ordinary income when restrictions are removed from any restricted stock he or she receives upon the exercise of the SAR.

4. Another feature often associated with either an ISO or an NSO is a reload option.
   a. Under a reload option, the employee is granted new options to purchase stock of the employer equal to the number of shares the employee uses to exercise the existing options.
   b. A reload option allows the employee to retain the same share of the corporation's future appreciation that he or she had before exercise of the existing option.
   c. If the reload option is to qualify as an ISO, the exercise price of the reload option must be equal to the fair market value of the employer's stock on the date the reload option is granted.
   d. If the stock used to exercise the option was purchased pursuant to an ISO, the use of the stock to exercise the option is a disqualifying disposition if the employee has not satisfied the holding period requirements.

   (1) Otherwise, the employee recognizes no gain if he or she uses existing stock as the exercise price. I.R.C. § 1036(a).

E. Restricted Stock.

1. Features.
   a. A corporation may sell or give to an employee as compensation stock that is restricted with respect to the ability of the employee to dispose of the stock before a certain date.

   (1) The restriction may be removed at the expiration of a certain period of time.
(2) The restriction may be removed upon the attainment of a stated objective.

b. If the employee terminates employment or the objective is not reached, the stock may be forfeited back to the company.

(1) The company may be required to pay the employee what he or she originally paid for the stock.

2. Tax Consequences.

a. To the employee.

(1) When the stock is no longer subject to a substantial risk of forfeiture or is transferable, the employee is taxed on the value of the stock to the extent it exceeds the amount paid by the employee at ordinary income tax rates as compensation income. I.R.C. § 83(a).

(a) An employee's right to stock is subject to a substantial risk of forfeiture if his or her ownership is conditioned upon the future performance of substantial services. I.R.C. § 83(c)(1).

(b) An employee's rights in stock are transferable only if a transferee can acquire rights that are not subject to a substantial risk of forfeiture. I.R.C. § 83(c)(2).

(c) In addition, so long as the sale of property at a profit could subject the person to suit under § 16(b) of the Securities Act of 1934, the person's rights in such property are subject to a substantial risk of forfeiture and are not transferable. I.R.C. § 83(c)(3).

i) Section 16(b) of the Securities Act of 1934 requires an insider (an officer or director) to pay to the corporation any profits the insider realizes upon the sale of stock followed by a purchase or by a purchase of stock followed by a sale within a six-month period.
a) Consequently, a recipient of stock could indefinitely postpone the recognition of income by acquiring stock immediately before the end of the most recent six-month period.

b) The regulations prevent this result by providing that the substantial risk of forfeiture terminates after six months, regardless of whether the restrictions under the Securities Act have actually terminated.


(2) If the employee makes an election under I.R.C. § 83(b) to have the value of the stock, to the extent it exceeds the amount the employee pays for the stock, includible in his or her income at the time the stock is acquired, the employee will not recognize additional income at the time the stock is no longer subject to a substantial risk of forfeiture or becomes transferable.

(a) The election must be made no later than 30 days after the stock has been transferred to the employee. I.R.C. § 83(b)(1) and (2).

(b) If the employee subsequently forfeits the stock, the employee will not be entitled to a deduction with respect to the stock in excess of any unreimbursed consideration paid for the stock. I.R.C. § 83(b), flush language.

i) Therefore, an employee should only make the election when he or she is certain that the value of the stock will increase.

(3) If the employee has paid fair market value for the restricted stock, determined without taking into account any restrictions other than a restriction that by its terms will never lapse, the I.R.C. § 83(b) election should always be made to avoid recognizing compensation income when the restriction is later removed.
(a) I.R.C. § 83 applies to restricted property transferred to an employee at fair market value, despite the absence of a compensatory bargain element. Alves v. Comr., 79 T.C. 864 (1982), aff’d, 734 F.2d 478 (9th Cir. 1984).

(b) The election will not result in any current income if the employee has paid fair market value for the stock, again without taking into account any nonlapse restrictions.

(c) The fair market value of restricted stock will be reduced if the stock also is subject to a restriction that by its terms will never lapse. Treas. Reg. § 1.83-5(a).
   
i) Such restrictions are typically placed on stock of closely-held corporations pursuant to buy-sell agreements.
   
ii) For example, if the employee is required to sell the stock back to the corporation upon termination of employment for any reason at a fixed price, the restriction will be a nonlapse restriction.

(d) If the value of stock has been reduced because of a nonlapse restriction, a subsequent cancellation of a nonlapse restriction by the corporation will cause the employee to recognize compensation income equal to any increase in value unless the employee can establish that the removal was not compensatory and that the corporation will not claim a deduction as a result of the cancellation. Treas. Reg. § 1.83-5(b).

b. To the corporation.

(1) The employer corporation will be entitled to a deduction at the same time as the employee recognizes income, either at the time the stock is no longer subject to a substantial risk of forfeiture or is transferable, or when the employee makes an election under I.R.C. § 83(b). I.R.C. § 83(h).
F. **Junior Stock.**

1. **Features.**
   a. Junior stock is a class of stock that has lesser voting, dividend and liquidation rights than common stock.
   
   b. Upon the achievement of certain stated objectives, the stock becomes convertible into common shares.
   
   c. For example, assume that the common stock of a corporation is trading at $10.00 a share. The corporation sells junior stock to an employee for $1.00 a share. The junior stock is convertible to common stock on a basis of five shares of junior stock for one share of common stock upon achieving a certain earnings objective. The employee will have a cost basis of $5.00 for each share of common stock having an initial value of $10.00.

2. **Tax Consequences.**
   a. To the employee.
      
      (1) In order for the employee to obtain favorable tax consequences, the purchase of the junior stock must not be treated as a taxable event.
      
      (a) In other words, the difference between the $5.00 that the employee pays for five shares of the junior stock and the $10.00 value of the common stock that the employee can obtain upon the achievement of certain performance objectives is not treated as compensation income to the employee.
      
      (b) Likewise, when the employee actually converts the junior stock into the common stock, no gain is recognized under I.R.C. § 1036.
      
      i) When the employee sells the common stock, he or she will recognize a capital gain equal to the difference between the price he or she paid for the junior stock and the amount realized on the sale of the common stock.
a) The benefits to the employee will be the deferral of the recognition of the gain, the ability to offset capital losses against the capital gain, and the lower tax rate applicable to net capital gains.

(2) The Internal Revenue Service has apparently never ruled on the consequences of a junior stock plan.

b. To the corporation.

(1) The corporation will not be entitled to a deduction either at the time the employee purchases the junior stock, at the time the employee converts the junior stock into common stock, or at the time the employee sells the common stock.

G. Phantom Stock.


a. In some cases, the employer may not want to give the employee an equity interest in the corporation, but does want to give the employee an opportunity to share in any increased value of the corporation.

b. On the other hand, an employee of a family-held corporation who is not a family member may not want to be a minority shareholder, but may want to benefit from the corporation’s financial success attributable to his or her efforts.

c. The use of phantom stock, which does not give the employee an equity interest in the corporation, is one way to accomplish this goal.

2. Features.

a. A phantom stock plan is essentially a deferred compensation plan under which the amount of deferred compensation is dependent upon the increase in the value of the shares of the corporation between the date of the grant and the date the employee is entitled to the deferred compensation.
b. For example, the corporation may grant to the employee units, which represent hypothetical shares in the corporation. The employee may be entitled to deferred compensation equal to the value of the shares at the time of grant and any appreciation in the value of the shares between the time of the grant and the time that the employee becomes entitled to a cash distribution. In addition, the employee may be entitled to an additional amount of deferred compensation based on the amount of dividends that would have been payable with respect to the number of units to which he or she is entitled during the period between the granting of the units and the payment to the employee.

3. Tax Consequences.

a. The employee will recognize ordinary income at the time that he or she actually or constructively receives the value of the phantom stock account.

b. The corporation will be entitled to a deduction equal to the amount that the employee is required to include in his or her income as a result of the actual or constructive receipt of the value of the phantom stock account.

c. Phantom stock will not be considered a second class of stock that disqualifies a corporation's Subchapter S election. PLR 9421011.

VII. GIFTS OF STOCK OPTIONS: TRANSFER TAX CONSEQUENCES

A. Introduction.

1. Background.

a. In the past, for a number of reasons, stock options granted to executives were nonassignable.


c. Securities law problems relating to short swing profits under Rule 16b-3 were eliminated on November 1, 1996.
d. While issuers still desire nonassignability in general to retain the incentive effect on employee performance, they are increasingly willing to allow assignments to family members and entities, such as trusts benefiting family members and limited partnerships (LPs) and limited liability companies (LLCs) wholly-owned by family members.

2. Planning Technique.
   a. The executive transfers a nonqualified stock option to a trust for the benefit of his or her children or to an LP or LLC and receives back interests in the entity that are then given to the children.

b. The value of the gift to the trust or the value of the interest in the LP or LLC for gift tax purposes is based on the fair market value of the option on the date of the gift to the trust or the transfer of the LP or LLC interests, which presumably will be very low, if not zero.

c. When the trust, LP, or LLC exercises the option, the executive reports the amount by which the fair market value of the stock purchased exceeds the option price as compensation income on his or her income tax return.

d. The trust, LP, or LLC presumably reports no taxable income as a result of the exercise of the option and has a basis in the stock purchased pursuant to the exercise equal to the amount paid for the stock under the option plus the income reported by the executive.

e. In the case of a trust, the stock will not be included in the executive’s federal gross estate if the executive has not retained any rights or powers that would cause inclusion under I.R.C. §§ 2036 through 2038 and in the case of an LP or LLC, only the fair market value of the interest in the entity retained by the executive at death will be included in his or her federal gross estate.

B. Transfer Tax Consequences.

1. Gift Tax.
   a. The assignment of a stock option to a trust should be a completed gift for federal transfer tax purposes if the executive has not
retained the right to revoke the assignment of the option. PLRs 9616035, 9514017, and 9350016.

(1) The gift should not be treated as incomplete even though the executive does not have a vested right to exercise the option at the time of the transfer or the option will terminate if he or she terminates employment or goes into competition with the employer that granted the option, although under the facts in the cited rulings, the options apparently were vested.

(2) The Service's earlier position that a death benefit only plan did not become a completed gift until the employee died was rejected by the Tax Court. Di Marco Est., 87 T.C. 653 (1986), acq. in result, 1990-2 C.B. 1.

(3) However, to be conservative, the option should be vested before the gift.

b. A gift to the trust may qualify for the annual exclusion if there is only one beneficiary who has the right to the income of the trust or the beneficiaries have Crummey withdrawal powers.

(1) In order to qualify for the annual exclusion, which allows a donor to give $10,000 per year per donee (and a husband and wife to give $20,000 regardless of who actually makes the gift), the donee must have a present interest, i.e., the right to enjoy the property immediately.

(2) A Crummey withdrawal power gives the beneficiary of the trust the right to withdraw the contribution to the trust (or a portion of the contribution if there is more than one beneficiary) for a period of time, such as 30 days, after which the right lapses.

(3) In Crummey v. Commissioner, 397 F.2d 81 (9th Cir. 1968), the Court held that such a withdrawal power gave the beneficiary requisite enjoyment to qualify for the annual exclusion, even though the beneficiary was a minor.

c. A transfer of an interest in an LP or LLC should qualify for the annual exclusion if it is an outright gift to an individual or if it is
a gift to a trust in which the beneficiaries have Crummey withdrawal powers.

d. A significant issue is the determination of the value of the gift.

(1) The simplistic approach would be to treat the value of the gift as the difference between the fair market value of the stock at the time of the transfer and the option price. See Rev. Rul. 196, 1953-2 C.B. 178.

(2) However, some other method, such as the Black-Scholes or Binomial model, is probably a more realistic way to determine the value.

(3) Under the Black-Scholes method, the following factors are taken into account in determining the value of an option at the date of the grant:

(a) Exercise price;

(b) Expected life of the option;

(c) Current price of the underlying stock;

(d) Expected volatility of the underlying stock;

(e) Expected dividends; and

(f) The interest rate currently available on a risk-free investment.


(4) The Service, in PLR 9616035, indicated that factors such as the possibility that the terms of the option may permit the options to be exercised without payment and the possibility that the committee may allow exercise of the options without payment, should be considered in valuing the options for gift tax purposes.
e. There may be an additional gift when the executive pays income tax on the income recognized at the time the option is exercised by the trust, LP, or LLC.

(1) The Internal Revenue Service (the Service) has taken this position in the case of a grantor retained annuity trust, where the grantor of the trust pays income tax on the entire income of the trust even though he or she may be receiving less than all the income pursuant to the required annuity payment.

(2) The Service has ruled that a trust receives a basis in the stock equal to the amount the trustee pays for the stock plus the amount of compensation income recognized by the executive. See PLRs 9449013 and 9449012.

(3) Regardless of whether an additional gift has occurred, the trust receives basis in the stock for income that was reported as taxable income on the donor’s (and not the trust’s) income tax return.

f. If the trust, LP or LLC does not have the cash to pay for the stock, it may use some of the shares purchased with loan proceeds to purchase additional shares, some of which can then be sold to pay back the loan.

(1) In the alternative, the executive may make an additional gift to provide the funds.

2. Estate Tax.

a. In general, there should be no inclusion under I.R.C. §§ 2036 through 2038 as long as the executive has not retained any rights or powers that would cause such inclusion. PLRs 9616035, 9514017, and 9350016.

(1) The executive could be a trustee of the trust without causing inclusion if any authority he or she has to distribute income or principal is subject to an ascertainable standard.

(2) The executive could be the general partner or member-manager of the LP or LLC without causing inclusion in his
or her estate as long as he or she is subject to a fiduciary
duty to the other owners.

(3) If the stock subject to the option is voting stock in a
controlled corporation, the executive should not retain the
right to vote the stock as a general partner or a member-
manager to avoid inclusion in his or her estate under
I.R.C. § 2036(b).

(a) A controlled corporation for this purpose is a
corporation in which the executive owns (applying
attribution rules under I.R.C. § 318), either alone
or in conjunction with any other person, the right to
vote stock possessing at least 20 percent of the total
combined voting power of all classes of stock.

(b) For a number of reasons, it is unlikely that options
will be granted to individuals in this situation.

(4) The fact that the option will terminate upon the executive’s
termination of employment will not be treated as a retained
right of the executive to affect the enjoyment of the option
under I.R.C. § 2036(a)(2) or to alter, amend, revoke or
terminate the option under I.R.C. § 2038.

b. Any gift taxes paid will be includible in the executive’s federal
gross estate if the executive dies within three years of the payment
of the tax.

c. In the case of an LP or LLC, the interest in the entity retained by
the executive at the date of death will be included in his or her
gross estate.

(1) The value of the interest will depend on the value of the
underlying assets, including any unexercised stock options,
and on the appropriate discounts or premiums applicable to
the interest in the LP or LLC retained by the executive.


a. A transfer of stock options to a skip person (including a trust in
which only skip persons have present interests) will be a
generation-skipping transfer to the extent not covered by the executive’s GST exemption (currently $1,000,000).

(1) A skip person includes a grandchild or a great-grandchild of the executive.

b. A transfer to a trust that is not a skip person will not be a generation-skipping transfer, but the executive may want to allocate the exemption to the trust.

(1) This may be a good way to leverage the GST exemption.

c. A transfer of a stock option at death to a skip person will be treated as any other transfer for generation-skipping transfer tax purposes.

(1) However, it may not be efficient to allocate an exemption to a stock option transferred to a trust that is not a skip person because when the option is exercised, the trust will recognize taxable income that will reduce the amount in the GST tax-exempt trust.

(2) The same is true with respect to direct skips of stock options at death.

(3) It may be more efficient to transfer stock options to nonskip persons and other assets to skip persons.

4. Special Valuation Rules.

a. If the option covers stock in a family-controlled corporation or a nonpublicly traded company, I.R.C. § 2701 may apply.

(1) If the shares subject to the option are common stock and the transferor is an older family member who has retained preferred stock, the value of the transferred options could be increased under the special valuation rules under I.R.C. § 2701.

(a) Generally, I.R.C. § 2701 applies when there is more than one equity interest in a corporation or partnership and an older family member transfers

42
residual equity interests to younger family members while retaining senior or preferred equity interests.

(b) In many cases the retained senior or preferred equity interests will be valued at zero for purposes of determining the value of the transferred residual equity interests.

(2) However, the Service has ruled privately that because an option is not an equity interest, the transfer will not be subject to I.R.C. § 2701. PLRs 9616035, and 9350016.

(a) Under the facts in PLR 9350016, the exercise price exceeded the fair market value of the stock at the time of grant.

b. The Service has ruled that I.R.C. § 2703(a) did not apply to a transfer of an option because it satisfied the three requirements of I.R.C. § 2703(b). PLR 9350016.

(1) I.R.C. § 2703 ignores certain options, rights or restrictions in determining the value of an interest transferred during lifetime or at death, unless the option, right, or restriction is a bona fide business arrangement, is not a device to transfer such property to members of the decedent’s family for less than full and adequate consideration in money or money’s worth, and its terms are comparable to similar arrangements entered into by persons in an arms’ length transaction.

(2) Such a right or restriction would include an option to purchase an interest in the entity, such as a stock option.

(3) If I.R.C. § 2703 applied, the value of stock held by the executive at his or her death would not be reduced as a result of any outstanding options to buy stock in the same corporation.

c. The Service has also ruled that I.R.C. § 2703(a) did not apply where the transferor and his or her family owned less than 50 percent of the corporation, and therefore the regulatory exception under Treas. Reg. § 25.2703(b) applied. PLR 9616035.
C. Income tax Consequences.

1. Grant.

a. Generally the grant of a nonqualified stock option to an executive will not result in taxable income to the executive in the year of the grant.

b. If the executive can demonstrate that the stock option has a readily ascertainable fair market value, the executive may make an election under I.R.C. § 83(b) to be taxed currently on the option.

(1) In many cases, the amount of compensation will be very small, arguably the difference between the fair market value of the stock and the exercise price, but see the discussion above concerning the value for gift tax purposes.

(2) By making the election, the executive receives a basis in the stock option equal to the fair market value of the option at the date of grant, and does not recognize any compensation income when the option is exercised.

(3) When the stock acquired through the exercise of the option is sold, the executive will recognize capital gain income equal to the excess of the amount realized over his or her basis in the stock, which is the amount recognized as compensation income at the time of the grant and the amount paid for the stock at the time of exercise.

(4) The Service has been reluctant to treat the grant of a nonqualified stock option as a taxable event because of the potential conversion of what would have been ordinary income at the time of the exercise into capital gain at the time the stock is sold by the executive.

c. Because the transfer to a family member is not an arm's length transaction, it will not be treated as a disposition under I.R.C. § 83, and the executive will not recognize income on the gift. PLRs 9714012, 9713012, and 9616035.
2. Exercise.

a. When the option is exercised, either by the executive during his lifetime, or by a trust, LP or LLC during the executive’s lifetime, the executive will recognize compensation income equal to the excess of the fair market value of the stock purchased pursuant to the exercise over the exercise price. PLRs 9714012, 9713012, and 9616035.

b. The issuing employer will be entitled to a deduction under I.R.C. § 83(h). PLRs 9714012, and 9616035.

c. The company should make some provision for withholding taxes when the trust, LP or LLC exercises the option and the executive has terminated employment or died.

(1) If the company withholds taxes from the shares purchased by the entity, the entity will be making a loan, or possibly a gift, to the executive, because it is satisfying a liability of the executive.

d. The trust, LP or LLC receives a basis in the stock it purchases equal to the amount it pays for the stock pursuant to the option and the amount of compensation income recognized by the executive, which should add up to the fair market value of the stock at the time of the exercise. PLRs 9714012, 9713012, and 9616035.

e. If the trust, LP or LLC exercises the option after the date of the death of the executive, it is not clear who recognizes the income, although presumably it should be the entity exercising the option. PLRs 9714012, and 9713012.

(1) If the executive held the option at the date of death, and the estate exercised the option, it would recognize ordinary income on the exercise of the option equal to the excess of the fair market value of the stock over the amount paid for the stock under the option.

(2) If the option were transferred to a trust or a beneficiary, as long as the transfer was not in satisfaction of a pecuniary bequest, the trust or individual beneficiary would have the same basis in the option that the estate would have, which is the amount, if any, the executive paid for the option and
the amount the executive recognized as compensation income when the option was granted if the executive made an election under I.R.C. § 83(b).

(3) This result should not be different if the option was acquired during lifetime by gift or by transfer to an LP or an LLC, although the Service has specifically refrained from ruling on the tax consequences to the transferee or the taxpayer [who would then be deceased] if the taxpayer is deceased at the time of the exercise of the transferred option. PLRs 9714012, and 9713012.

3. Disposition.

a. Upon disposition of the stock acquired pursuant to the option, the trust, LP or LLC will recognize capital gain income equal to the difference between the consideration received in exchange for the stock and its basis in the stock.

D. For a more detailed discussion of this issue, see Assignment of Executive Stock Options and Related Developments, by J. Edward Shillingburg, Tax Management Memorandum, Vol. 37, No. 26, December 23, 1996.