INCENTIVE COMPENSATION ARRANGEMENTS

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This outline provides an overview of available incentive compensation arrangements for key employees, directors, and/or other service providers.

1. STOCK

The principal goal of an incentive stock arrangement is to align the economic interests of the corporation's management with the interests of its shareholders.

1.1 Disadvantages

Although incentive arrangements involving stock are widely used, there are several disadvantages:

1.1(a) The value of the stock can rise or fall for reasons that are unrelated to the employee's role in the business.

1.1(b) Because closely-held C corporations generally do not pay dividends on their common stock, the only way the employee can liquidate his investment is by terminating his employment; this provides an incentive to *terminate* his employment that is out of alignment with the employer's goal of retaining key employees.

1.1(c) Transferring stock to employees gives them substantial additional legal rights.

- Holders of shares in California corporations are entitled to notice of and to vote at shareholders' meetings for the following:

- ⇒ Election of directors;[1]
- ⇒ Amendments to the articles of incorporation, including amendments to limit the liability of directors or to permit broad indemnification of officers and directors;[2]
- ⇒ The creation of new classes of stock or making existing shares subject to assessments;[3]
- ⇒ The sale of substantially all of the corporation's assets;[4]
- ⇒ A merger of the corporation with another corporation and certain other reorganizations;[5] and
- ⇒ The dissolution of the corporation.[6]

- ♦ Nonvoting stock can be used, but the right to vote on some issues remains.[7] Terminating an S corporation election by voluntary revocation requires the consent of a majority of all shares, including nonvoting shares.[8] So shareholders who want to retain control should always keep a majority of *all* classes of stock.

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1 Cal. Corp. Code §§ 301, 600, 601, 602, 603.

2 Cal. Corp. Code §§ 902, 903, 904.

3 *Id.*

4 Cal. Corp. Code § 1001.

5 Cal. Corp. Code §§ 1201, 1201.5, 1202, 1203.

6 Cal. Corp. Code §§ 1800, 1900.

7 Cal. Corp. Code §§ 903, 904, 1201, 1800.

8 I.R.C. § 1362(d)(1)(B).

1.1(d) Even if the participants in the incentive arrangement receive nonvoting stock, the directors and the majority shareholders will have a special duty to them as minority shareholders.[9]

- This will reduce the flexibility of the majority shareholders in any sale of the business.

- For example, in the sale both the seller and the buyer may benefit by limiting the portion of the purchase price allocated to stock or assets and allocating a portion of the purchase price to employment agreements, covenants not to compete or consulting agreements with the principal shareholders.

  However, such an allocation might reduce the purchase price received by the minority shareholders, possibly entitling them to legal remedies against the directors and the majority shareholders.

1.1(e) Shareholders are also entitled to complain about the fairness of transactions (including employment and rental arrangements) that the corporation enters into with members of its board of directors or with entities in which the directors have an interest.[10] In some cases, they can also maintain derivative suits in the corporation's name.[11]

1.1(f) Holders of stock in California corporations are entitled to the following:

- A list of names and addresses of all other shareholders and the number of shares they each hold;

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[9] *Jones v. H. F. Ahmanson & Co.*, 1 Cal. 3d 93 (1969).

[10] Cal. Corp. Code §§ 310, 800.

[11] Cal. Corp. Code § 800.

- Annual financial statements;

- Information about transactions between the corporation and either directors, officers or their other corporations;

- Information about indemnification of corporate officers, directors or agents;

- To inspect and copy the corporation's accounting books and records for purposes reasonably related to their interests as shareholders; and

- The number of votes for, against or abstaining on any proposal submitted for a shareholder vote or for the election of directors (but not how each shareholder voted).[12]

  Note: The ownership of shares does not impose any duty to keep this information confidential.

  Although employees and directors have fiduciary duties to the corporation,[13] it is not clear that those duties apply to information that is available to employees or directors in their capacities as shareholders.

1.1(g) The consent of each holder of shares (voting or non-voting) and of each spouse who has a community property or other joint interest in shares is required to elect S corporation status. Increasing the number of shareholders makes it more difficult to obtain this unanimous consent. In many cases, it is best to make the S election before the shares are issued or the options are granted.

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[12] Cal. Corp. Code §§ 1501, 1509, 1600, 1601.

[13] *Gower v. Andrews*, 59 Cal. 119 (1881); Cal. Corp. Code § 309.

1.1(h) The **number** of shareholders of an S corporation cannot exceed 100 (counting a husband and wife as a single shareholder, and subject to the election to count each family as one shareholder).[14] And electing S corporation status requires the **unanimous consent** of the shareholders and their spouses who have community property interests in the shares.[15]

Accordingly, by issuing stock a C corporation might reduce its chances of ever enjoying the tax benefits of S corporation status.

1.1(i) The stock must be bought back with after-tax dollars, unless the company uses an ESOP.

Note: Notwithstanding these concerns, employers frequently permit employees to acquire shares of the employer corporation.

1.2 When and How to Use Stock as an Incentive

1.2(a) Rank and file employees generally should not receive direct ownership in stock.

If it is desirable to provide stock to them as an incentive, then an employee stock ownership plan (an "**ESOP**") should be used. To derive the maximum benefit from an ESOP, management must gain a good working understanding of the benefits of the ESOP and must constantly educate the work force about those benefits.

1.2(b) It might be necessary to allow the mission-critical members of the management team to acquire stock to cement their commitment to the company during a difficult management transition.

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[14] I.R.C. § 1361(b)(1), (c)(1).

[15] Treas. Reg. § 1.1362-6(b)(2)(i).

The key non-family managers should sign **buy-back agreements** allowing the company to buy all of their stock when they retire.[16] The key family managers should have buy-back agreements allowing the family members who stay in the business to buy the voting stock (or *all* of the stock) of family members who leave the business.

If the company is an S corporation, all shareholders should sign an agreement with provisions that minimize the risk of an unplanned termination of the S corporation election.

1.2(c) To provide an incentive for the next tier of management and to retain the second-tier management through the transition period, consider implementing a performance share plan for second tier management when the first tier receives stock.[17]

1.3 How the Shares Are Acquired by the Employee

1.3(a) The shares can be issued or transferred to the employee for the fair market value of the shares on the date of transfer, for some amount less than the full market value or as a "**stock bonus**," without any payment by the employee.

1.3(b) In the alternative, the employee can receive an option to acquire shares of employer stock under either "an incentive stock option plan" or a "nonqualified stock option plan."

- Incentive stock options had a limited role for several years after the Tax Reform Act of 1986.[18] The 1993

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[16] See page 27 for the "**Buy-Sell Agreement Checklist**."

[17] See page 27 for the outline "**Succession Planning - Transferring a Business to the Next Generation**."

[18] The differences between incentive stock options and nonqualified stock options are not discussed in this outline. If you would like more information about stock option arrangements, see page 27 for the bulletin "**Incentive Stock Options, Nonqualified Stock**

(..continued)

tax rate increases increased the spread between the tax rates for ordinary income and capital gain, thereby enhancing the value of incentive stock options.

- The "exercise and hold" requirement for ISOs limits their usefulness for closely-held corporations, because the employees rarely exercise before termination of employment or the sale of the company. In those cases, the ISOs become nonqualified stock options.

1.3(c) To provide an additional incentive for the employee to remain with the company or to achieve specific goals, employers frequently delay the employee's acquisition of the stock or place temporary restrictions ("**golden handcuffs**") on the employee's rights in the stock.

1.3(d) Although the shares can be acquired by the employee from either the corporation or an existing shareholder, generally the corporation issues the shares.[19]

Note: The tax consequences are much more straightforward if the corporation issues the shares.[20]

1.4 Exercise Schedules and Vesting Arrangements

1.4(a) The principal alternatives:

Options and Cash Compensation Programs," which discusses the tax requirements, tax treatment, advantages and disadvantages of each.

[19] If a shareholder sells or gives the shares to the employee for less than the fair market value of the shares, the shareholder is treated as contributing shares to the corporation and the corporation is treated as transferring the shares to the employee. Treas. Reg. § 1.83-6(d)(1). Not very straightforward.

[20] *See* Treas. Reg. § 1.83-6(d). Securities law restrictions might affect transfers from shareholders.

- The employee can receive the shares immediately (or the options can be exercisable immediately).

- In the alternative, after the employee acquires the stock, his or her right to realize the full fair market value of the stock when he disposes of it can "**vest**" either at a future date or in increments over time. In that case, his rights in the stock are subject to a "**substantial risk of forfeiture**."

  Example 1: Sarah received a stock bonus of 100 shares of ABC Co. stock in December, 2005, when they were worth $1,000 each. She paid nothing for the shares.

  Her right to receive the full value of the shares when she disposes of them vests in 20 shares each year on January 1 in 2006, 2007, 2008, 2009 and 2010.

  If she terminates employment with ABC Co. before 2011, she forfeits the non-vested shares -- that is, she must return them to ABC Co. without any compensation for them.

  At the termination of her employment, ABC Co. must buy from her any vested shares at their market value at that time.

  In March, 2008 Sarah terminates her employment with ABC Co. when the value of each share is $2,000. She has 40 non-vested shares which she returns to ABC Co. for no compensation. For her 60 vested shares, she receives $120,000 from ABC Co. She has a basis in her three 20-share blocks of vested shares equal to the value of each block on the date that it vested. In each case, the value on the vesting date was less than $2,000 per share. Accordingly, she has long-term capital gain on the shares that vested in 2006 and 2007, and short-term capital on the shares that vested on January 1, 2008.

- As a third alternative, the employee can receive the shares (or the option can become “**exercisable**”) over a period of time or when specified goals are achieved.

  Example 2: Sarah received a stock option for a total 100 shares of ABC Co. stock in December, 2005, when they were worth $1,000 each. She paid nothing for the option. The price to exercise the option to buy a share is $1,000, payable in cash at exercise.

  The option becomes exercisable as to 20 shares each year on January 1 in 2006, 2007, 2008, 2009 and 2010. Once the option becomes exercisable, it remains so until Sarah exercises it, until she terminates her employment, or until the year 2015, whichever comes first.

  If she terminates employment with ABC Co., the shares stop becoming exercisable and she has 30 days to exercise any options that were exercisable at the date of the termination.

  At the termination of her employment, ABC Co. must buy her shares at their market value at that time.

  In March, 2008 Sarah terminates her employment with ABC Co. when the value of each share is $2,000. She has options to acquire 60 shares. She elects to exercise the options on all of these shares. Because her purchase and her sale back to ABC Co. will occur at the same, ABC Co. simply gives her $60,000 (($2,000 x 60) - ($1,000 x 60)), which is treated as ordinary income for tax purposes and is subject to wage withholding as a bonus. If ABC Co. properly and timely reports and withholds on this income, it can deduct $60,000 in its year ending February 28, 2009 (its tax year in which ends Sarah’s year of receiving the income).

1.4(b) Generally, stock is “vested” if on any disposition of it by the employee he will realize its full value.

1.4(c) Stock is "**non-vested**" if, when the employee disposes of it, the employee receives less than its full value because a predetermined milestone has not been achieved before the disposition.

- Typically, the employee receives the lesser of what he or she paid for non-vested shares (perhaps, but rarely, with an interest factor to compensate for the company's use of the employee's funds, or the value on the date he sells them).

- The disposition of non-vested stock is commonly called a "**forfeiture**" (although this term technically means a return of the stock for no consideration). The possibility that the milestone will not be achieved and that the stock will be surrendered for less than its full value is called a "**substantial risk of forfeiture**" in tax lingo.[21]

- The period during which the stock is non-vested is known as the "**vesting period**."

- For example, a vesting arrangement might provide a stock bonus to the chief financial officer, but if he terminates employment for any reason within five years, he must return the stock to the company without receiving any payment for it. However, this restriction will "**lapse**" (that is, it will terminate) if the company's initial public offering occurs before the expiration of the five-year period. If the CFO sells the stock after the restriction lapses, he will receive its full value at that time.

1.4(d) Vesting arrangements include "**cliff**" vesting, where 100% of the shares become vested as of a particular date or when a specified event occurs (for example, all of the shares become vested when the company's annual sales

[21] I.R.C. § 83(c)(1).

reach $1 million or at the initial public offering), or staggered vesting, in which a percentage of the shares vest as specified milestones are achieved (for example, 20% of the stock becomes vested at the end of each year for five years).

1.4(e) Stock subject to a vesting arrangement is known as "**restricted stock**."

1.5 Golden handcuffs

1.5(a) Arrangements that prevent an employee from immediately acquiring all of the shares allocated to him or that impose a vesting arrangement are sometimes called "**golden handcuffs**" because they provide him with a special incentive to continue the employment relationship.

1.5(b) Although the incentive effect is similar, *deferring the transfer* of the shares to the employee has substantially different tax and legal consequences than a *vesting* arrangement.

Generally, if the employee is very optimistic that (1) the value of the shares will increase during the vesting period and (2) the conditions will be satisfied (that is, that he or she will remain employed until all of the shares vest, or that the company will reach the specified targets while he or she remains employed), *and* the employee has the cash to pay any current tax or can get the employer to cover that tax, then the employee will prefer restricted stock to a stock option. This is because the employee can minimize the tax cost of acquiring the shares by making a Section 83(b) election when restricted stock is received.

1.6 Tax Issues When Stock is Used

1.6(a) Vesting

- Generally, for tax purposes the employee is treated as receiving additional compensation income when the employee's rights in the stock become vested.[22]

- The amount of compensation equals the excess of the fair market value of the stock on the date that it becomes vested over the amount the employee pays for it.[23] That excess is sometimes called the "**spread**."

- If the employer properly treats the spread as compensation for income tax withholding purposes, the employer will be entitled to a deduction for that amount.[24]

- The employee may elect at the time that he receives non-vested stock to treat the stock for tax purposes as if it were vested.[25]

  ⇒ If this "**Section 83(b) election**" is made, the employee takes into income in the year that he receives the non-vested stock the excess of the fair market value of the shares on the date of the transfer over the amount, if any, that he pays for the stock.

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[22] I.R.C. § 83(a); Cal. Rev. & Tax. Code § 17081 (incorporating I.R.C. § 83).

[23] *Id.* This amount is also "wages" subject to FICA taxes. Rev. Rul. 79-305, 1979-2 C.B. 350 (property subject to vesting); Rev. Rul. 78-185, 1978-1 C.B. 304 (property not subject to vesting). The plan or agreement can specify the source of cash to cover these taxes.

[24] I.R.C. § 83(h); Treas. Reg. § 1.83-6.

[25] I.R.C. § 83(b); Treas. Reg. § 1.83-2.

- ⇒ The employer is entitled to its deduction at that time, subject to the withholding rule.

- ⇒ If the election is made, there are no tax consequences when the stock eventually becomes vested.

  Note: The Section 83(b) election must be filed within 30 days after the stock is issued. *This is a very short fuse and requires careful planning and diligent follow-up.*

♦ Until a "**transfer**" occurs, the employee cannot make the Section 83(b) election for non-vested property and is not treated as receiving vested property.[26]

- ⇒ A transfer occurs when the employee will have both the upside benefits and the downside risks when the stock vests.

- ⇒ If the employee is protected from a drop in value or if the employee's right to participate in the appreciation in the property's value is capped (for example, if his/her employment is terminated for cause), then no transfer occurs until the limitations are dropped or the property is disposed of; the entire amount of the spread at that time is ordinary income to the employee and, subject to the withholding rule, deductible by the employer.

- ⇒ For shares subject to an option, the transfer occurs only when and to the extent that the option is exercised (unless the option is actively traded on an established market).

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[26] I.R.C. § 83(b); Treas. Reg. § 1.83-3(a).

⇒ If the stock is paid for with a nonrecourse promissory note (employer looks only to the pledged stock for payment), the transaction is treated as an option to buy stock that is partially exercised as each payment is made on the note. *Avoid using nonrecourse notes and always examine the note and pledge documents to be sure that they are clearly full recourse (employer looks to all of employee's assets for payment, not limitations).*

1.6(b) **The Employee's Tax Basis in the Shares**

To determine whether to make the Section 83(b) election, it is necessary to understand the effect of the election on the tax basis in the stock.

- The employee's tax basis in vested stock equals the fair market value of the shares on the date that the stock becomes vested.[27]

- The employee's tax basis in non-vested stock for which he/she makes a Section 83(b) election is the value of the shares on the date he/she acquires them.[28]

- The employee's tax basis in other non-vested stock is the amount, if any, that he/she pays for it.[29]

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[27] Treas. Reg. § 1.61-2(d)(2)(i), (6)(i).

[28] Treas. Reg. § 1.83-2(a).

[29] Treas. Reg. § 1.83-1(b)(2).

1.6(c) **Disposing of the Stock**

- **Vested Stock** (or Non-vested Stock With an 83(b) Election)

  ⇒ If the employee disposes of vested stock at a gain, the gain will be capital gain.[30]

  ⇒ If the employee disposes of vested stock at a loss, the loss will be short-term or long-term capital loss, depending on whether he held the stock for more or less than one year after the later of the Section 83(b) election or the vesting date.[31]

  ⇒ These rules also apply to non-vested stock for which the employee made the Section 83(b) election.

- **Non-vested Stock** (No 83(b) Election)

  ⇒ In contrast, if the employee forfeits or otherwise disposes of non-vested stock (and the employee did not make a Section 83(b) election):

  ⇒ If the amount that the employee receives for the stock is less than the employee's tax basis, the employee will have an ordinary loss;[32] and

  ⇒ If the amount that the employee receives for the non-vested stock exceeds his tax basis, the excess will be ordinary income and the employer will be

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30 I.R.C. §§ 1221, 1222.

31 *Id.*; Treas. Reg. § 1.83-4(a).

32 Treas. Reg. § 1.83-1(b)(2).

entitled to its deduction, subject to the withholding rule.[33]

1.6(d) When to Make the Section 83(b) Election

- The Section 83(b) election provides tax advantages if the value of the stock increases during the vesting period, but results in tax disadvantages if the stock either is forfeited or does not increase substantially in value during the vesting period.

- Generally, an employee would make the Section 83(b) election if he believed (1) that he would not forfeit his stock during the vesting period and (2) that the value of his stock would increase substantially during that period.

  - ⇒ Making the election accelerates his tax payment (the taxable event becomes the acquisition of the stock, rather than the expiration of the vesting period), but he/she pays tax on what he/she believes to be the lower "spread" on the earlier date.

  - ⇒ If the employee holds the stock for more than one year, the appreciation in value will be taxed at preferential long-term capital gain rates. Without the election, the appreciation would be ordinary income. The tax is imposed when the employee sells the shares.

  - ⇒ The employer's deduction is also accelerated.

- However, if the employee makes the Section 83(b) election and then either forfeits the shares or otherwise disposes of them at a loss, he/she will have a capital loss.

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[33] Treas. Reg. §§ 1.83-1(b)(2), 1.83-6(a).

⇒ If the employee had not made the election, he/she would have either no loss or an ordinary loss that could offset compensation income.

⇒ Capital loss first offsets capital gain; a net capital loss can offset no more than $3,000 of an individual's ordinary income in any year.[34] An individual's unused capital loss can be carried forward indefinitely until it is exhausted.[35]

1.7 Payment by the Employee

1.7(a) There are several ways that the employee can pay for the shares. (As noted above, the employee can also receive the shares for no payment as a "stock bonus.")

1.7(b) The employee can pay for the shares with cash, a promissory note or a combination of the two.

- Generally, the note should bear interest at a rate at least equal to the minimum rate necessary to avoid imputed interest for tax purposes.[36]

- Although a California corporation is generally prohibited from issuing shares at less than their fair market value and from accepting a promissory note in payment for the issuance of its stock, statutory exceptions apply when the stock is issued to employees pursuant to an employee stock purchase plan.[37]

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[34] I.R.C. §§ 1211(b), 1222.

[35] I.R.C. § 1212(b).

[36] I.R.C. § 7872.

[37] Cal. Corp. Code §§ 408, 409.

- ♦ It is also possible for the employee to pay for the shares (or to satisfy the income tax withholding obligation) with previously acquired stock or a portion of the stock acquired when an option is exercised; however, these methods of payment raise unresolved tax issues.

1.8 Paying the Employee's Section 83 Tax

1.8(a) If the price to be paid by an employee for stock is less than the market value of that stock, another consideration is whether the employer will pay the employee's income tax on the stock issuance.

1.8(b) There is no requirement that the employer do so.

1.8(c) As noted above, the employer receives a deduction in the amount of the excess of the fair market value of the stock over the amount the employee pays for the shares on the date that either the stock becomes vested or the employee elects to have the stock treated as vested for tax purposes. The employee takes this amount into income.

Note: By paying all the employee's tax, an employer with substantial taxable income can "trade" its "extra" deduction resulting from the stock issuance for the employee's "extra" income resulting from the stock issuance.

- ♦ In effect, such an employer pays to the Internal Revenue Service and the California Employment Development Department as employee income tax withholding the same tax dollars that it would otherwise pay as corporate tax.

- ♦ The employer's deduction is available only if the employer properly reports the employee's income from the transaction for income tax withholding purposes.

  Example: In 2005 Sarah received stock valued at $100,000 as a stock bonus. Both Sarah and her employer

(a C corporation) were in a 40% combined federal and California tax bracket. Sarah owed tax of $40,000 and her employer was entitled to a $100,000 deduction (subject to the reporting and withholding rule) worth $40,000.

The employer decided to "give up" its deduction to cover Sarah's taxes. The employer declared a cash bonus of $67,000 to Sarah, but paid $18,000 to the California Employment Development Department and $49,000 to the Internal Revenue Service as income tax withholding for Sarah. Sarah's tax on the total compensation of $167,000 ($100,000 + $67,000) was $67,000, so all of her income tax was covered. Her employer's deduction was $167,000, which reduced the employer's taxes by $40,000. In effect, the employer used cash it would have paid to tax authorities as the employer's tax and instead paid the same amount to cover Sarah's taxes.

1.8(d) Under this "**tax bonus**" or "**gross-up**" arrangement, the employee takes a basis in the stock equal to its market value on the date it is issued ($100,000 for Sarah in the above example) and has capital gain (or loss) when he later sells the shares.

1.8(e) This works best with a stock bonus or a bargain sale to the employee, because the employer can be reasonably certain of its tax status before going forward. If the employer has a tax loss, the "tax bonus" provides no immediate tax reduction to the employer, so it creates negative cash flow. Accordingly, this technique is rarely used with stock option plans.

Note: The additional compensation will reduce pre-tax earnings for financial statement purposes. Because the employer's taxes are also reduced, there should be little effect on after-tax income. These financial accounting issues should be explored with the employer's accountant.

1.9 Securities Laws

- ♦ Issuing stock and granting options to employees raise important securities law issues that are beyond the scope of this outline, but should be considered in the design of the program.

- ♦ Note: The securities laws apply to the *grant* of the option -- not the issuance of the shares. Registration or permit requirements must be satisfied or, if an exemption from these requirements is available for the transaction, federal and state filings or disclosure may be required.

1.10 Buy-Back Arrangements

1.10(a) In addition to issues involving the acquisition of shares by the employee, the employer should also consider how the shares will be retrieved when the employee terminates employment, when the employee becomes divorced or when the employee or the employee's spouse dies.

1.10(b) The corporation may also wish to retrieve the shares in the event that its principal shareholders decide to sell their shares to a third party.

1.10(c) The buy-back agreement should be signed at the time the employee receives the options to acquire the shares. If there is no option involved, the employee should sign the buy-back agreement when the employee gets the shares.

2. STRUCTURED BONUS ARRANGEMENTS

2.1 Phantom Stock

To avoid the many negative consequences of issuing stock to employees, employers often consider the alternative of establishing a structured bonus plan (also called a "phantom stock" or "performance share" plan).

Note: Although participants in these plans do not have the shareholder's statutory rights to financial statements and other corporate information, they should receive sufficient information about the

company to know if their benefits under the plan are being correctly computed.

- These are formal, written arrangements by which the company promises to pay additional cash compensation to the employee in amounts determined by reference to specific goals.

- These goals can be tied to the performance of the employee or the employee's work group, the company's earnings or increases in the market value of the company's stock.

- Such arrangements include "**stock appreciation rights**" or "**SARs**" which permit the employee to share in the increase in the value of shares from the date that the employee becomes a participant in the plan to a specified future date, such as the date of termination of employment.

2.2 Deferred Compensation Plans

Payment under these plans can be made annually or can be deferred until a specified future date (for example, five years from the end of the year to which the bonus relates, or at retirement).

2.2(a) Arrangements that permit or require the employee to defer the receipt of the payment until after the year in which it is "earned" are known as "**deferred compensation plans**."

- In a deferred compensation plan, the employee is an unsecured creditor of the employer with respect to the amount that the employer promises to pay to the employee.

- Securing the amount due to the employee or segregating it in a trust that is not subject to the employer's creditors would accelerate the employee's receipt of the income (which otherwise occurs in the year the employee receives or can demand and receive the payment; the employer's deduction also occurs at that time).

- The employee's funds can be set aside in a special trust that is not available to the employer's creditors unless all of the employer's other assets are exhausted.

  This type of trust is known as a "**rabbi trust**," because the Internal Revenue Service first approved this arrangement in response to an inquiry from a rabbi.

  With these deferred compensation plans, the employee must ask "Am I deferring income from a year with low tax rates on compensation income to a year with a higher tax rate on that income?"

- In a "**secular trust**", the trust assets are *not* available to the employer's creditors. This means that the employee is taxed when the employer contributes to the trust. The trust can be designed so that the employee -- not the employer or the trust -- is taxed on the trust income. These are most often used when federal income tax rates for individuals are lower than the rates for C corporations. Generally, there is no tax to the employee when the funds are distributed.

  Note: Under this arrangement, the only benefit of putting the funds in trust -- rather than paying them to the employee directly -- is to impose on the employee a forced savings regime.

2.2(b) The entire amount received under these plans is **ordinary income** to the employee and deductible compensation paid by the employer.

- From the employee's perspective, "real" stock has the advantage of possible long-term capital gain treatment when the employee disposes of it.

- However, the employer must use nondeductible, after-tax dollars to buy its shares back from the employee.

2.2(c) Deferred compensation arrangements must comply with the requirements of **Section 409A**, enacted in 2004, to provide income deferral and to avoid penalty taxes. *Many pre-2005 deferred compensation arrangements will need to be amended in 2005 to avoid a tax disaster.*

2.2(d) FICA taxes are due when the amount is credited to the employee's account, if it is vested. If it is not initially vested, it is subject to FICA taxes when it vests.[38] *Note that FICA taxes – including the employee's portion – can be due years before the amounts are paid to the employee.*

3. GOLDEN PARACHUTES

- The directors of corporations that are being groomed for sale or are in the process of selling the business often recognize that the transition increases the anxiety level of key employees and causes them to consider seeking employment elsewhere -- even though losing key employees could substantially affect the viability of the transaction or could result in a reduced purchase price.

- Employers in this situation frequently consider promising to pay to the employee a special bonus if the employee remains employed until the sale is closed or for a specified time after the sale. This type of deferred compensation plan is known as a "golden parachute."

- The amount payable to the employee may be determined by reference to the sale price for the business (perhaps reduced by the tax that the corporation will be required to pay on a sale of its assets).

- If the amount to be paid to the employee under the golden parachute arrangement is more than three times the employee's average annual compensation of the three prior years, the employer's deduction for

[38] I.R.C. § 3121(v)(2)(A). There is no second FICA tax when the amount is actually paid. Treas. Reg. § 31.3121(v)(2)-1(a)(2)(iii).

the payment may be disallowed and a 20% penalty tax may apply to the employee's income.[39]

4. INSURANCE ARRANGEMENTS

- Although cash is often the most effective incentive, arrangements are also available for using life or disability insurance or annuities as incentive compensation. These arrangements may be attractive to employees who are in the market for additional insurance.

- Proposals involving an employer's purchase of insurance for the benefit of an employee must always be compared to a cash payment by the employer to the employee to enable the employee to buy insurance (possibly in an insurance trust that will keep the proceeds out of the employee's estate).

5. OTHER CONCERNS

5.1 Non-Intuitive Tax Consequences

Before implementing an incentive compensation arrangement, the tax consequences – including new Section 409A – must be explored in detail.

5.2 ERISA

The Employee Retirement Income Security Act of 1974, as amended ("ERISA"), may also apply.

5.3 Financial Accounting and Loan Covenants

An incentive compensation arrangement may affect the employer's income statement. For a closely-held business, this can affect loan covenants. *Because the financial accounting treatment of these arrangements differs in many respects from the treatment for income tax purposes, any specific proposals should be reviewed by the corporation's accountants before announcing to employees the adoption of the proposal.*

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[39] I.R.C. §§ 280G, 4999.

5.4 Compensation Consultants

When an employer considers adopting an incentive compensation plan, compensation consultants can provide substantial value.

- ♦ Consultants can design a plan that advances the company's strategic plan.
- ♦ Consultants can speak with employees to assure that the proposed plan will actually create an incentive. Sometimes the time horizon of employee's is shorter than the employer's, and stock is less attractive to them than cash, even deferred cash taxed at ordinary income rates.

5.5 Offhand Promises

Officers should proceed with extreme caution in any discussions with an employee concerning the employee's possible right to acquire an interest in the business.

5.5(a) No commitment should be made to any employee before the proposal has been thoroughly evaluated from a legal, tax and financial accounting standpoint with respect to its effects on the employer.

5.5(b) Casual statements such as "when this business does well, you'll do well," "I consider you my partner," "don't worry, you will share in any sale of this business" or even "I am going to talk to my lawyer this afternoon about getting you some stock in this company" can easily lead to inflated expectations and should be avoided.

Employees will not forget such statements and will regard them as promises (which, in some circumstances, courts may enforce).

5.6 Gifts of Options

A gift of a nonqualified option is a completed gift for income gift and estate tax purposes on the later of the date of the gift or the

date that the option becomes exercisable and the shares acquired at exercise become vested.[40] The Black-Sholes model (or some modification of it for stock that is not actively traded) can be used to value the option for gift tax purposes.[41]

[End of outline.]

[40] Rev. Rul. 98-21, 1998-1 C.B. 975.

[41] Rev. Proc. 98-34, 1998-1 C.B. 983.

ADDITIONAL INFORMATION

If you would like to receive additional information about these issues, please check the appropriate box below, provide your address (or attach your business card) and return this sheet to the speaker -- or FAX it to Sarah Rognlie at (818) 936-2990

1. **Buy-Sell Agreement Checklist**. For those considering adopting or revising a buy-sell agreement.*

2. **Incentive Stock Options, Nonqualified Stock Options and Cash Compensation Programs** (bulletin). The tax requirements, tax treatment, advantages and disadvantages.*

3. **Tax Pitfalls of Buy-Sell Agreements** (bulletin). How a recent Tax Court case illustrates some of the problems created by a poorly planned buy-sell agreement.*

4. **Succession Planning – Transferring the Business to the Next Generation** (outline with 8 case studies). Tax and corporate law techniques that can ease the transition. Includes a summary of the tax law issues.*

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