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Executive Compensation Tax Update, 2013

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Legislative efforts to reign in executive compensation coupled with renewed shareholder activism supported by an active plaintiffs' bar continue to add layers of complexity to an area rife with compliance challenges. In an effort to assist employers and practitioners in their struggle to stay ahead of the curve, this article focuses on providing a summary of the recent tax law developments impacting executive compensation practices.

INCOME, EMPLOYMENT AND INVESTMENT TAXES

Recent tax legislation has focused on taking a larger bite out of the apple with respect to compensation paid to executives by increasing both income and employment tax rates. As Congress debates whether further changes will be necessary to address Federal deficit and budgetary constraints, employers will likely face efforts to modify current compensation practices to create a more tax-efficient compensation structure for executives.

New 39.6% Income Tax Rate — Effective for 2013, the American Taxpayer Relief Act of 2012 (the

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"Act")[3] added a new 39.6% individual income tax bracket that will apply to income over the following thresholds:[4]

Table I

Filing Status	Threshold Amount
Married filing jointly	$450,000
Married filing separately	$225,000
Single	$400,000
Head of household (with qualifying person)	$425,000
Qualifying widow(er) with dependent child	$450,000

Additional 0.9% Medicare Tax Rate — Effective for 2013, the Act also imposes an additional 0.9% Medicare tax on individuals with wages or self-employment income in excess of the following threshold amounts:

Table II

Filing Status	Threshold Amount
Married filing jointly	$250,000
Married filing separately	$125,000
Single	$200,000
Head of household (with qualifying person)	$200,000
Qualifying widow(er) with dependent child	$200,000

When added to the existing 1.45% Medicare tax, individuals with wages will be subject to a 2.35% Medicare tax on amounts in excess of the threshold. In the case of self-employed individuals, the Medicare tax will rise to 3.80% on amounts in excess of the threshold.[5] The additional 0.9% Medicare tax, however, is not imposed on employers — only employees and self-employed individuals (i.e., no employer matching payment).

For purposes of the new Medicare tax, wages will include compensation under stock-based awards (e.g., stock options, restricted stock, SARs, RSUs, PSUs, etc.). To the extent the award is structured as non-qualified deferred compensation (e.g., certain RSUs, or RSUs with deferral features), the special timing rule would apply.[6]

New 3.8% Medicare Passive Investment Income Tax — Effective for 2013, the Health Care and Education Reconciliation Act of 2010 imposes a new 3.8% Medicare tax on net investment income for individuals with adjusted gross income in excess of the applicable threshold amount (see Table II above).[7] Net investment income is the excess of gross investment income over investment deductions, and includes, but is not limited to, interest, dividends, non-qualified annuities, rent and royalty income, and the net gain from the disposition of property (e.g., gains from the sale of stocks, bonds and mutual funds). Wages and self-employment income, however, are not subject to this tax.

The IRS has published proposed regulations and FAQs to provide guidance on this new tax.[8] Notably, the proposed regulations provide that amounts paid to an employee under a nonqualified deferred compensation plan (or that otherwise become includible in income under §§409A, 457(f), 457A, or any other Code section or tax doctrine) that include interest or other earnings are *not* treated as net investment income. This is the case even if the interest or earnings are excluded from FICA wages under the special timing rule (e.g., future earnings credited to vested deferred amounts).

Capital Gains and Qualifying Dividends — Effective for 2013, §§102(a) and 102(b)(1) of the Act raise the long-term capital gains and qualifying dividends tax rate to 20% (from 15%) for taxpayers with adjusted gross income in excess of the applicable threshold amount (see Table I above). Coupled with the new Medicare net investment income tax, which applies to capital gains, high-income earners will pay tax on capital gains at a rate of 23.8%.

Future Changes to Compensation Structures? — Even with the new changes in the tax rates, the spread between the maximum aggregate tax rate of 41.95% on wages and the maximum aggregate tax rate of

[3] The American Taxpayer Relief Act of 2012, P.L. 112-240, §101(b)(1)(B), amending §1 of the Internal Revenue Code of 1986, as amended (the "Code"). All section references herein are to the Code and the regulations thereunder, unless otherwise indicated.

[4] Rev. Proc. 2013-15, 2013-5 I.R.B. 444. Dollar amounts are subject to adjustment for inflation for tax years after 2013.

[5] The 2.90% regular Medicare tax plus the 0.9% additional Medicare tax.

[6] See discussion below under the heading "*Special Timing Rule for Nonqualified Deferred Compensation*."

[7] §1411, added by P.L. 111-152, §1402(a)(1). The employer is not required to withhold for this tax, as it is subject to individual estimated tax under §6654. The IRS issued proposed regulations under §1411, generally proposed to be effective for taxable years beginning after Dec. 31, 2013, but taxpayers may rely on the proposed regulations for purposes of compliance with §1411 until the effective date of the final regulations. REG-130507-11, 77 Fed. Reg. 72611 (12/5/12).

[8] *See* REG-130507-11, 77 Fed. Reg. 72612 (12/5/12), and http://www.irs.gov/uac/Newsroom/Net-Investment-Income-Tax-FAQs.

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23.8% on capital gains continues to remain significant.[9] While it is too early to discern whether employers will modify their compensation practices to increase the tax efficiency for their executives, it is likely that executives will desire to convert ordinary income into capital gains as soon as possible. Taxpayers who are contemplating making §83(b) elections on restricted stock, however, must be aware of the inherent tax risks associated with any such election.[10]

In the context of cash compensation, it is likely that executives will consider increasing the amount of their deferred compensation. In this regard, FICA taxes, including the additional 0.9% Medicare tax, will apply at vesting pursuant to the special timing rule. Once taxed, however, future notional earnings will not be subject to additional FICA taxes, including the 0.9% additional Medicare tax and the 3.8% Medicare tax on net investment income.

EMPLOYERS NEED TO MODIFY WITHHOLDING PROCEDURES

In light of this increase to the highest individual income tax rate, supplemental wages in excess of $1,000,000 will now generally be subject to withholding at a rate of 39.6%.[11] Employers are also required to withhold the additional 0.9% Medicare tax and will need to make changes to their existing payroll practices. The IRS has published FAQs and proposed regulations to provide guidance to employers on their withholding obligations.[12] Most notably, the IRS has instructed that:

- Employers must withhold the additional Medicare tax on all wages paid to an employee in excess of $200,000, regardless of the employee's filing status.
- To the extent excess Medicare tax is withheld, the employee will receive a credit against the total tax liability shown on his or her tax return.
- The additional Medicare tax only applies to amounts above $200,000. If a single payment (e.g., a bonus) causes the employee's wages to exceed the threshold, employers may not apply the additional Medicare tax to the entire payment (only the amount in excess of $200,000).

IRS Information Letter 2012-0063 — The IRS recently clarified that flat rate withholdings on supplemental wages cannot vary from the percentage required by the regulations.[13] Accordingly, even if an employee has requested that additional tax be withheld, the employer cannot increase the applicable withholding rate on supplemental wages. However, with respect to supplemental wages up to $1 million, this restriction does not apply if the employer is using the aggregate approach.[14]

In the context of stock-based compensation, employers must be aware of the fact that withholding in excess of the minimum statutory withholding rate can lead to liability accounting treatment for the entire award (versus the more favorable equity accounting treatment). In order for a company to classify a stock-based award as equity, the plan should not permit the employee to require withholding in excess of the applicable statutory minimum tax rates (federal, state, local and payroll) and, as a matter of practice, the employer must not withhold taxes in excess of the statutory minimum rates.[15] Additionally, not all state, local and foreign taxing jurisdictions have established supplemental statutory rates for purposes of withholding on supplemental wages. In situations where a taxing jurisdiction has not established a minimum statutory withholding rate, the authors understand that accounting firms are advising their clients that *any withholding* would result in liability accounting treatment. Accordingly, employers should discuss and review their withholding procedures with their outside accountants to ensure that their procedures are in compliance with applicable accounting guidance.

Special Timing Rule for Nonqualified Deferred Compensation — The new 0.9% Medicare tax applies to amounts deferred under nonqualified deferred compensation plans. Under a special timing rule contained in the existing FICA regulations, nonqualified deferred compensation is subject to employment taxes at the later of when the services are performed or when

[9] For example, with respect to a married taxpayer filing jointly, a maximum tax rate of 41.95% (39.6% + 2.35%) will apply on wages over $450,000. For the same taxpayer, however, the maximum aggregate tax rate on capital gains will be 23.8% (20% + 3.8%).

[10] See discussion below under the heading "*Section 83(b) Elections and Inherent Risk to Employee*."

[11] Regs. §31.3402(g)-1(a)(2).

[12] *See* http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Questions-and-Answers-for-the-Additional-Medicare-Tax, and http://www.irs.gov/irb/2012-52_IRB/ar18.html. *See also* REG-130507-11, 77 Fed. Reg. 72611 (12/5/12).

[13] At the time the letter was issued in 2012, the mandatory withholding rate was 35%. Beginning in 2013, the mandatory withholding rate increased to 39.6%. *See* Regs. §31.3402(g)-1(a)(2).

[14] Under this aggregate method, the employer combines the supplemental wages with the employee's regular wages and applies the withholding rate that the employee elected on the Form W-4.

[15] FASB Accounting Standards Codification ("FASB ASC") Topic 718 (718-10-25-18 through 718-10-25-19).

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there is no longer a substantial risk of forfeiture.[16] Once taxed, no additional FICA taxes are imposed on future earnings credited to the deferred amounts. In the context of equity compensation, certain equity awards could fall within the definition of non-qualified deferred compensation depending on their terms (e.g., certain RSUs, or RSUs with deferral features).

While the special timing rule is not elective, many employers continue to fail to apply the special timing rule and withhold as required. Employers who have failed to take nonqualified deferred compensation into account as FICA wages may want to consider correcting open tax years. With respect to years prior to 2013, Rev. Rul. 2009-39 sets forth interest-free adjustment procedures and should allow corrections to occur at the 1.45% Medicare tax rate. To the extent not corrected, the nonduplication rule will not apply and all distributions (including the earnings) will be subject to the then current FICA tax rates. Additionally, employers who have failed to properly apply the special timing rule could be subject to various penalties.[17]

In the context of the new 0.9% Medicare tax, the proposed regulations under §3102(f) provide that, to the extent the additional Medicare tax is not withheld by the employer, the employee is liable for the tax. The proposed regulations also provide that the IRS will not collect from an employer the amount of the additional Medicare tax it failed to withhold from wages paid to an employee if the employee subsequently pays the additional Medicare tax. The proposed regulations, however, provide that the employer would remain subject to any applicable penalties or additions to tax for the failure to withhold the additional Medicare tax.

SERP Acceleration — In addition to the special timing rule, the FICA tax regulations also contain special rules governing benefits earned under a non-account balance plan (e.g., a plan that determines benefits based on a formula, such as a SERP). Under the rules applicable to a non-account balance plan, benefits earned are not required to be taken into account as FICA wages under the special timing rule until the first date on which the amount is reasonably ascertainable.[18] *An employer, however, may elect to include amounts earned under a non-account balance plan that are not reasonably ascertainable at any earlier date selected by the employer.*[19]

In plain English, where the amount of the benefit under an NQDC plan can fluctuate in the future under the plan's benefit formula, an employer is not required to include amounts earned under a non-account balance plan in FICA wages until the actual amount of the benefit is known. In a non-account balance plan, the ultimate benefit to be paid is typically not known until the participant retires, as factors such as age, years of service, average compensation and offsets can and do fluctuate prior to the final benefit determination. An employer, however, has the option to elect to include the amount of benefits earned as FICA wages at an earlier date elected by the employer, subject to certain requirements (e.g., the amount reported as FICA wages must be trued-up when the actual amount of the benefit becomes known).

Due to concerns that FICA tax rates could increase in the near future, many tax practitioners had previously advised their clients to accelerate the taxation of FICA wages under existing SERPs. For most participants, only the un-capped Medicare tax applied, as most if not all of the participants had wages in excess of the Social Security tax wage base. Employers who have not taken advantage of this alternative, however, may still do so. If history is any indication, FICA taxes will likely continue to increase periodically as the demands on Social Security and Medicare increase with an aging population.

SECTION 83

Section 83 governs the income tax treatment of the transfer of property (e.g., employer stock) in connection with the performance of services.[20] Under §83, if property is transferred to a person in connection with the performance of services, the fair market value of the property received in excess of the amount paid is included in the service provider's gross income in the first taxable year in which the rights to the property are either transferable or no longer subject to a substantial risk of forfeiture. Under existing Regs. §1.83-3(c), the transfer of property is considered subject to a substantial risk of forfeiture if the person's right to such property is conditioned upon the future performance of substantial services or the occurrence of a condition related to the purpose of the transfer.

[16] Regs. §31.3121(v)(2)-1(a)(2).

[17] For example, employers are potentially liable for a late deposit penalty under §6656 (equal to 10% of its share of FICA taxes); information reporting penalties under §§6721 and 6722 (generally limited to $100 per incorrect W-2); and a negligence penalty under §6662 (equal to 20% of the underpayment).

[18] Regs. §31.3121(v)(2)-1(e)(4)(i)(A).

[19] *Id.*

[20] To review the IRS's Audit Techniques for Stock Based Compensation, see: http://www.irs.gov/Businesses/Corporations/Stock-Based-Compensation-Audit-Techniques-Guide-(02-2005) (Last Reviewed or Updated: Apr. 2, 2013).

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Proposed Regulations Under §83 — The IRS has recently issued proposed regulations under §83[21] that are intended to clarify the scope of a *substantial risk of forfeiture*. More specifically, the proposed regulations clarifying three noted areas of ambiguity by providing that: (i) a substantial risk of forfeiture may be established *only* through a service condition or a condition related to the purpose of the transfer; (ii) the *likelihood* that a condition related to the purpose of the transfer will occur must be considered in determining whether a substantial risk of forfeiture exists; and (iii) transfer restrictions, including transfer restrictions that carry the potential for forfeiture or disgorgement of the property, do not give rise to a substantial risk of forfeiture. Once finalized, the proposed regulations will apply to property transferred on or after January 1, 2013.[22]

With respect to whether other conditions may give rise to a substantial risk of forfeiture, existing case law has created some confusion on this issue. For example, in *Robinson v. Comr.*,[23] the First Circuit Court of Appeals held that a provision in a stock option agreement that required Robinson to sell his shares back to his employer, at his original cost, if he attempted to dispose of the option shares within one year from the date of exercise, was found to be a substantial risk of forfeiture. The proposed regulations, however, make clear that a substantial risk of forfeiture may be established only through a service condition or a condition related to the purpose of the transfer.

Similarly, the IRS recognized that confusion has arisen as to whether a taxpayer must consider the "*likelihood*" that a condition related to the purpose of the transfer will occur in determining whether a substantial risk of forfeiture will exist. In this regard, the Treasury Department and the IRS have indicated that they do not believe a substantial risk of forfeiture exists in situations where it is extremely unlikely that the forfeiture condition will occur. Accordingly, the proposed regulations clarify that *both* the likelihood that a forfeiture event will occur and the likelihood that the forfeiture condition will be enforced must be considered in determining whether a substantial risk of forfeiture exists. This clarification, in particular, has the potential to impact the manner in which performance goals are established with respect to performance-based awards. Accordingly, employers will need to establish performance conditions that are sufficiently demanding to ensure that they actually give rise to a substantial risk of forfeiture for purposes of §83.

The proposed regulations also clarify that transfer restrictions, including restrictions that carry the potential for forfeiture or disgorgement or other forms of penalties, do not create a substantial risk of forfeiture. This change essentially incorporates the IRS conclusions in Rev. Rul. 2005-48,[24] where the IRS held that an employee was taxable upon the exercise of a nonstatutory stock option notwithstanding the fact that the stock obtained upon the exercise of the option was subject to restrictions on sale under Rule 10b-5 of the Securities Exchange Act of 1934 or pursuant to certain contractual provisions.[25] In this regard, the Proposed Regulations make clear that restrictions such as lock-up agreements or insider trading restrictions under Rule 10b-5 of the Exchange Act will not be considered a substantial risk of forfeiture for purposes of §83.

> *Effect of Clawback Provisions?* — While not specifically identified in the proposed regulations, this clarification should also apply to property that is subject to a clawback under policies adopted by publicly-traded companies in order to comply with §954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Section 83(b) Elections and Inherent Risk to Employee — Under §83(b) and Regs. §1.83-2(a), the recipient of restricted property (e.g., restricted stock) may elect to include in gross income the excess of the fair market value of the property transferred over the amount paid for such property. If this election is timely made, the excess of the fair market value of the property received over the amount paid for such property is included in gross income at the time of transfer even though such property may remain substantially nonvested and subject to forfeiture. No compensation, however, will generally be includible in gross income when such property subsequently becomes substantially vested. A §83(b) election is made by filing a written statement with the IRS, and must be filed not later than 30 days after the date on which such property has been transferred. In Rev. Proc. 2012-29,[26] the IRS issued sample language that may be used for purposes of making a §83(b) election.

More notably, Rev. Proc. 2012-29 also contains guidance concerning the tax consequences of making

[21] REG-141075-09, 77 Fed. Reg. 31783 (5/30/12).

[22] Prop. Regs. §1.83-3(l); 77 Fed. Reg. at 31785. Taxpayers, however, may rely on the proposed regulations with respect to property transferred after May 30, 2012, the date of publication in the Federal Register.

[23] 805 F.2d 38 (1st Cir. 1986), *rev'g* T.C. 444 (1984).

[24] 2005-2 C.B. 259.

[25] *See also Tanner v. Comr.*, 117 T.C. 237 (2001), *aff'd*, 65 Fed. Appx. 508 (5th Cir. 2003).

[26] 2012-28 I.R.B. 49.

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a §83(b) election, including the tax consequences if the taxpayer forfeits the restricted property on which the §83(b) election was made. The examples contained in Rev. Proc. 2012-29 confirm the inherent risk in making a §83(b) election, including:

- If the shares are forfeited, the taxpayer is *not* entitled to a deduction or credit for the income taxes paid as a result of making the §83(b) election; and
- The only instance in which a taxpayer may have a capital loss to report is when the taxpayer actually paid for the property. Under these circumstances, the taxpayer can recognize a loss to the extent the amount received upon forfeiture is less than the amount paid for the property. For this purpose, income recognized upon the filing of the §83(b) election is *not* added to the taxpayer's basis for purposes of calculating the loss.

SECTION 162(m)

Section 162(m) limits the tax deduction publicly-traded companies can claim for compensation paid to certain executive officers to the extent it exceeds $1,000,000 per year.[27] Performance-based compensation, as defined under §162(m) and associated regulations, is exempt from this limitation. There are numerous conditions that must be met for awards to be considered performance-based compensation, including the requirement that the underlying plans be approved by shareholders and that the awards be payable only upon the attainment of one or more pre-established, objective performance goals.

With regard to stock options and stock appreciation rights, there are special conditions that must be met for these types of awards to satisfy the performance goal requirement. In particular, Regs. §1.162-27(e)(2) requires that the plan under which a grant is made state the maximum number of shares with respect to which the stock options or stock appreciation rights may be granted during a specified period. In addition, under the terms of the option or right, the amount of compensation the employee could receive must be based solely on an increase in the value of the stock after the date of the grant.[28] The regulations further provide that compensation attributable to a stock option or stock appreciation right will not satisfy the performance goal requirement to the extent that the number of options granted exceeds the maximum number of shares for which options may be granted to the employee as specified in the plan. The IRS has also issued proposed regulations that would amend Regs. §1.162-27(e)(2) to clarify that the requirement that the plan state the maximum number of shares with respect to which the stock options or stock appreciation rights may be granted during a specified period *applies on an individual employee basis*.[29]

Shareholder Derivative Litigation — Plaintiffs' attorneys continue to bring derivative suits against corporations and their boards challenging the corporation's compliance with §162(m). The lawsuits allege, among other things, that (i) the corporation failed to comply with the procedural requirements of §162(m), (ii) the corporation's proxy contained false and misleading statements by failing to disclose that awards violated the terms of the plan, did not qualify as performance-based compensation, or would not be tax-deductible, and (iii) fiduciary duties owed to the company and its shareholders were breached. In addition, during the past year numerous shareholder lawsuits have been filed alleging that corporations have issued stock options or other stock-based awards in excess of the plan's stated limits and/or individual award limits.

Several recent targets of lawsuits involving the issuance of equity awards in excess of plan limits include Quiksilver,[30] Simon Property Group,[31] AmerisourceBergen,[32] DeVry,[33] Abaxis,[34] Stillwater Mining[35] and Healthways.[36] The types of relief sought in these cases include, among others, the rescission of

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[27] To review the IRS's Audit Techniques for §162(m), *see*: http://www.irs.gov/Businesses/Corporations/Section-162(m)-Audit-Techniques-Guide-(02-2005) (Last Reviewed or Updated: Apr. 2, 2013).

[28] For this purpose, compensation is determined without regard to any dividend equivalent rights, provided that the payment of the dividend equivalent is not made contingent on the exercise of the option.

[29] Prop. Regs. §1.162-27.

[30] *Vladimir Gusinsky Living Trust v. McKnight*, No: 8190-VCL (Del. Ch., filed 1/8/13).

[31] *Shepherd v. Simon*, No: 7902-CS (Del. Ch., filed 9/25/12).

[32] *Mor v. Collis*, No: 1:13-cv-00242-UNA (D. Del., filed 2/15/13); *IClub Inv. P'ship v. Collis*, No: 2:13-cv-00688-PBT (E.D. Pa., filed 2/7/13).

[33] *Donnawell v. Hamburger*, No: 1:12-cv-09074 (N.D. Ill., filed 11/12/12).

[34] *St. Louis Police Ret. Sys. v. Severson*, No: 4:12-cv-050806-YGR (N.D. Cal., filed 9/1/12). In this case, Abaxis Inc. proposed to correct awards in excess of plan limits by an amendment that would have removed certain limits on the issuance of restricted stock units and increased the total number of shares available for issuance under the plan. The court enjoined the shareholder vote on the proposed amendment to the plan in order for the company to supplement its proxy statement and disclose that the company issued common stock upon settlement of restricted stock unit awards in excess of the stated plan limits. The court found that by failing to disclose the excess awards, the proxy statement did not accurately depict the purposes or effects of the proposed amendment, and that such information was material to the shareholders' vote.

[35] *Jurgelewicz v. McAllister*, Docket No. 1:13-cv-00047 (D. Mont., filed 4/4/13).

[36] *Pfeiffer v. Leedle*, No: 7831-VCP (Del. Ch., filed 9/4/12).

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excess awards, disgorgement of the proceeds of excess awards, invalidation of the shareholders' approval of the plan, enjoining the annual shareholder meeting, and reformation of corporate governance procedures.[37]

While the impetus for express plan limits is principally to ensure compliance with §162(m), exceeding such shareholder-approved limits is an open invitation for claims by shareholders. For example, the Stillwater Mining Company's (the ''Company'') 2004 Equity Incentive Plan (the ''Plan'') has an individual award limit equal to 250,000 shares per calendar year. The Company's Compensation Committee (the ''Committee''), however, exceeded this limit by making grants of restricted stock units (''RSUs'') under the Plan to the Company's CEO in the amount of 332,000 RSUs in 2009, 337,447 RSUs in 2010 and 267,512 RSUs in 2012.[38] In response to a recent shareholder derivative claim and with the consent of the CEO, the Committee rescinded 82,000 shares in respect of the 2009 award, 87,447 shares in respect of the 2010 award and 17,512 shares in respect of the 2012 award. In a supplemental filing to the Company's Proxy Statement, the Company noted:

> *However, the compensation committee and Mr. McAllister determined, despite the cost to Mr. McAllister personally, the costs and distraction of litigation were not in the best interests of the Company and its shareholders and agreed the most prudent course of action would be to rescind the grants that exceeded the cap.*[39]

While it remains to be seen whether any of the other plaintiffs will be successful in these cases, issuing awards in excess of plan limits is certainly one error that could be easily avoided by establishing and following proper grant procedures.

Outside of the claims relating to excess grants, the majority of §162(m) cases to date have generally not been successful. Most recently, in *Freeman v. Adams*,[40] the Supreme Court of Delaware upheld the Chancery Court's finding that the board of directors of XTO Energy, Inc. did not commit waste by failing to adopt a plan that could have made its $130 million of bonus payments deductible under §162(m). Notably, the court held that the board's intentional decision not to implement a performance-based compensation plan under §162(m) in order to retain flexibility in compensation decisions, while being well-aware of the tax laws at issue, was a ''classic exercise of business judgment.''

In *Seinfeld v. Slager*,[41] however, the Delaware Chancery Court recently held that certain awards to Directors were not protected by the business judgment rule. The plaintiffs claimed that the directors of Republic Services, Inc. committed waste by awarding unreasonable compensation to themselves in the form of restricted stock units under the company's equity plan. Despite the fact that the shareholder-approved plan specifically contained an aggregate share limit of 10,500,000 shares and an individual award limit of 1,250,000 shares per year, the court noted:

> *The Stock Plan before me puts few, if any, bounds on the Board's ability to set its own stock awards. The Plan itself provides that the Committee, comprising the Directors themselves, has the sole discretion, in terms of restrictions and amount, over how to compensate themselves.*[42]

In this regard, the court concluded that even though the stockholders approved the plan, the Directors were *interested* in self-dealing transactions under the plan, as the plan lacked sufficient definition to afford the Directors protection under the business judgment rule. Given the lack of sufficient limitations under the plan, the court refused to grant the motion to dismiss and held that the awards to Directors must be evaluated under a fairness standard.

> *Effect of Slager?* — The more definite the terms of a plan, the more likely that a board's compensation decision will be labeled disinterested and qualify for protection under the business judgment rule. Accordingly, corporations should consider reviewing the grant terms under existing equity plans to determine whether current limits should be modified and resubmitted to shareholders for approval.

[37] In many of the cases, there are other issues surrounding the excess awards, such as excessive compensation, misleading or retroactive plan amendments to increase share limits with respect to which stock-based awards were granted, changes from calendar year to fiscal year plan limits, and separate plan limits for different types of stock-based awards.

[38] *See* http://www.sec.gov/Archives/edgar/data/931948/000134100413000408/form8k.htm (Form 8-K, dated Apr. 10, 2013).

[39] *See* http://www.sec.gov/Archives/edgar/data/931948/000119312513153269/d519374ddefa14a.htm (Schedule 14A, Definitive Additional Materials).

[40] *Freeman v. Adams*, 58 A.3d 414 (Del. 2013).

[41] *Seinfeld v. Slager*, 2012 BL 165263 (Del. Ch. 2012).

[42] The court was persuaded by the fact that the Board could have theoretically awarded to each of the 12 existing Directors 875,000 restricted stock units in calendar year 2009 (with an aggregate value totaling more than $260 million).

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Other notable §162(m) derivative suits that are still pending include Caterpillar[43] and Viacom.[44] In the Caterpillar case, the plaintiffs sued the executive officers for breach of fiduciary duty, waste of corporate assets, and unjust enrichment related to alleged false and misleading statements in the proxy statement to the effect that awards under the corporation's long-term incentive plan were expected to qualify as tax-deductible, performance-based compensation under §162(m). In particular, the complaint alleges that the plan contained significant flaws relating to the performance criteria such that compensation paid under the plan could not qualify as performance-based compensation, or be deductible, under §162(m). In the Viacom case, the plaintiffs sued the executives and board of directors for breach of fiduciary duty, waste, unjust enrichment and equitable relief seeking a new shareholder vote to approve the incentive plan. The complaint alleges that the compensation committee improperly used discretionary, *subjective* factors to award bonuses under the plan, and that the use of such subjective criteria was inconsistent with §162(m).

Rev. Rul. 2012-19 — On June 21, 2012, the IRS issued Rev. Rul. 2012-19,[45] to clarify the treatment of dividends and dividend equivalents paid/credited on performance awards, and whether such amounts are subject to the $1,000,000 deduction limit under §162(m). Under Regs. §1.162-27(e), dividend and dividend equivalents are treated as *separate grants* and will not be considered performance-based compensation unless they separately satisfy the requirements of §162(m). Two examples are used to clarify this point:

In Situation 1, Corporation X grants restricted stock and RSU awards that are intended to qualify as performance-based compensation. Under the terms of the awards, dividends and dividend equivalents credited thereon are accumulated, vest and become payable only if the performance conditions related to the awards are satisfied. Under these facts, the IRS concludes that the dividends and dividend equivalents qualify as performance-based compensation.

In Situation 2, Corporation X grants restricted stock and RSU awards that are intended to qualify as performance-based compensation. Under the terms of the awards, dividends and dividend equivalents are paid at the same time dividends are paid on the common stock of Corporation X regardless of whether the performance goals are satisfied. Under these facts, the IRS concludes that the dividends and dividend equivalents *do not* qualify as performance-based compensation.

Although these holdings are not surprising, they serve as a useful reminder that dividends and dividend equivalents may not be deductible in all situations. One issue that the IRS did not discuss, however, was the issue of withholding. If dividends and dividend equivalents are paid out prior to the vesting of restricted stock (or the vesting and issuance of shares underlying RSUs), such amounts are treated as wages and are subject to withholding.[46]

Common Mistakes — Based on IRS audit activity in this area, the IRS continues to find a number of failures, including: (i) making mid-year changes to performance goals; (ii) making adjustments to the performance goals that were not pre-determined (e.g., adjusting for subsequent events); (iii) failing to obtain shareholder re-approval of the plan; (iv) paying awards out upon retirement or an involuntary termination; (v) using performance measures that are not included in the shareholder approved plan; (vi) paying out the compensation before the compensation committee certifies in writing that the performance goals were obtained; and (vii) issuing stock options in excess of plan limits. Aside from IRS compliance, and perhaps most importantly, corporations must take care to ensure that proxy disclosures do not suggest or imply that the corporation's plan and awards *will* qualify as performance-based compensation under §162(m). The use of language such as "may comply" or "is intended to comply" may protect the corporation from allegations of false or misleading statements in the proxy materials. Additionally, disclosures for shareholder approval or re-approval of a plan should be rigorously reviewed to ensure that they are drafted in compliance with the requirements of §162(m).

Section 162(m)(6) and Proposed Regulations — For taxable years beginning or after January 1, 2013, the Patient Protection and Affordable Care Act, P.L. 111-148, (the "Affordable Care Act") imposes an annual $500,000 deduction limit, per individual, on compensation paid by certain health insurance companies.[47] More specifically, §162(m)(6) limits to $500,000 the allowable deduction that may be claimed by a "covered health insurance provider" for the aggregate "applicable individual remuneration" and "deferred deduction remuneration"[48] paid to an officer, director, employee or other individual service

[43] *City of Lansing Police and Fire Ret. Sys. v. Calhoun*, cv-01076-UNA (D. Del., filed 8/27/12).

[44] *Freedman v. Redstone*, cv-01052-UNA (D. Del., filed 8/17/12).

[45] 2012-28 I.R.B. 16.

[46] Rev. Proc. 80-11, 1980-1 C.B. 616.

[47] *See* §162(m)(6).

[48] "Deferred deduction remuneration" is remuneration for services that is deductible in a later tax year (e.g., nonqualified deferred compensation). Whether remuneration is deferred deduction remuneration is determined based on when the remuneration

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provider. The IRS recently released detailed and complicated proposed regulations that provide guidance on this new deduction limitation.[49] Taxpayers may rely on the proposed regulations until the issuance of the final regulations.

For purposes of §162(m)(6), the proposed regulations define a ''covered health insurance provider'' to include any insurance company, insurance service or insurance organization (including an HMO): (1) that is subject to state law insurance licensing and regulation, and (2) in which 25% or more of its gross premiums from providing health insurance coverage are from the provision of ''minimum essential coverage'' (coverage that an individual must obtain under the Affordable Care Act to avoid being subject to penalty).[50] Under the proposed regulations, a health insurance provider's status as a covered health insurance provider is determined on a year-by-year basis and therefore an insurer may be a covered health insurance provider in one year, but not in the next year. Additionally, subject to certain exceptions, members of a covered health insurance provider's controlled group are treated as a single employer for purposes of determining whether each such entity is a covered health insurance provider. Accordingly, controlled group members can also be subject to the deduction limitation even if the member is not a health insurance issuer and does not provide health insurance coverage. The proposed regulations, however, confirm that an employer will not be a covered health insurance provider by reason of the fact that the employer maintains a self-insured medical plan.

The deduction limit imposed under §162(m)(6) is significantly more stringent than the $1,000,000 deduction limit imposed on the compensation paid to covered employees of a publicly-traded corporation under §162(m)(1). In this regard, notable differences include:

- The deduction limit under §162(m)(6) applies to privately-held as well as publicly-traded companies.
- The deduction limit under §162(m)(6) applies to all employees and other service providers (excluding certain bona fide independent contractors) who provide services to a covered health insurance provider, and is not limited solely to the CEO and three other most highly-compensated officers.
- Section 162(m)(6) contains no exceptions for performance-based compensation, including stock options or stock appreciation rights.
- The deduction limit under §162(m)(6) continues to apply to compensation paid to applicable employees and services providers following their termination of employment and/or service.

For purposes of applying the $500,000 limit, the proposed regulations create an additional layer of complexity by requiring that covered health insurance providers allocate compensation to the specific tax year(s) in which it was earned. For example, if a service provider earns the right in 2013 to a $150,000 deferred payment (payable upon separation from service) and receives $400,000 in other remuneration for the year, the $400,000 compensation will be deductible in 2013. In the year in which the $150,000 deferred payment is made, however, only $100,000 of such amount will be deductible (and the remaining $50,000 will not be deductible regardless of the amount of the service provider's compensation for such year). In this regard, the proposed regulations set forth separate attribution rules (and in some cases, alternative attribution rules) for each of the following types of compensation: nonqualified deferred compensation (account balance plans and non-account balance plans), stock options and stock appreciation rights, restricted stock subject to a substantial risk of forfeiture, involuntary separation pay, reimbursements and in-kind benefits, and split-dollar life insurance. In light of these attribution rules, covered health insurance providers will need to establish additional recordkeeping procedures to properly track and calculate the deductible and non-deductible portions of deferred compensation payments.

SECTION 409A

Section 409A governs the taxation of nonqualified deferred compensation arrangements.[51] Failure to satisfy the requirements of §409A could result in the ac-

is deductible, regardless of when it is paid. For example, the deduction of a bonus paid within 2½ months following the calendar year for which the bonus is earned would be allowable in the prior calendar year.

[49] Prop. Regs. §1.162-31, REG-106796-12, 78 Fed. Reg. 19950 (4/2/13), proposed to apply to taxable years that begin after Dec. 31, 2012, and end on or after Apr. 2, 2013.

[50] There is a *de minimis* exception whereby a taxpayer is not treated as a covered health insurance provider if the premiums received by the taxpayer (and all other members of its controlled group) from providing minimum essential health insurance coverage are less than 2% of the gross revenue of the taxpayer (and all other members of its controlled group) for the taxable year. In addition, if the taxpayer is exempt from §162(m)(6) based on the *de minimis* exception in one year, but fails to meet the criteria for the exception in the next year, there is a one-year grace period in which the taxpayer will not be treated as a covered health insurance provider for the first year in which it does not meet the exception.

[51] To review the IRS's Audit Techniques for nonqualified de-

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celeration of income recognition to the recipient, substantial interest and an additional 20% tax in the year in which such compensation is no longer subject to a *substantial risk of forfeiture*. While there are a variety of common mistakes that employers make in this area, a few items are deserving of additional attention at this time.

Discounted Stock Options — In *Sutardja v. U.S.*,[52] one of the first court cases to address an alleged violation of §409A, the Court of Federal Claims confirmed that discounted stock options constitute nonqualified deferred compensation for purposes of §409A. Discounted stock options are typically not designed to comply with §409A (e.g., no fixed exercise date) and therefore would be subject to accelerated income recognition upon vesting (as opposed to upon exercise), an additional 20% income tax penalty as well as an additional interest penalty.[53] To this end, the CEO argued that the discounted stock options were exempt from §409A, as the options were actually exercised within the short-term deferral period (i.e., within 2½ months of the end of the year in which the stock options vested). Notably, the court stated that even if the taxpayer exercised the stock options within the applicable short-term deferral period, the short-term deferral exception did not apply because the stock option agreement did not *require* the taxpayer to exercise the stock options within the short-term deferral period.

This case highlights the importance of establishing proper procedures for establishing and documenting the fair market value of employer stock for purposes of setting the exercise price for stock rights (i.e., stock option prices and SARs). This is particularly true in the case of privately-held companies where the stock price cannot readily be established by reference to the trading price on an established national stock exchange.

In the context of a privately-held corporation, the final regulations under §409A provide specific guidance on the alternative methods by which a corporation can determine the fair market value of its stock for purposes of establishing the exercise price of a stock option. The general rule is that the stock must be valued based on *a reasonable application of a reasonable valuation method*.[54] Whether a valuation method is reasonable (or has been reasonably applied) will be evaluated based on the facts and circumstances. A valuation methodology, however, will not be considered reasonable if it does not take into account all available information material to the value of a corporation.

To satisfy the foregoing standard, it is not necessary that a taxpayer demonstrate that the fair market value was determined by an independent appraisal. *Rather, the standard will be met if the corporation can otherwise demonstrate that the valuation was determined by a reasonable application of a reasonable valuation method.* It should be noted, however, that the fact that the corporation has acted in "good faith" will not protect against a deficient valuation. Although an independent appraisal is not required, the final regulations do establish a rebuttable presumption that a valuation of stock reflects its fair market value if the valuation is based upon an independent appraisal by a qualified appraiser.[55] Under this safe-harbor, the presumption is rebuttable only by a showing that the valuation is *grossly unreasonable*.[56] Accordingly, while not required, the use of a qualified independent appraiser will undoubtedly provide an employer with the greatest protection in the event of an IRS audit.

The final regulations also include a rebuttable presumption for certain start-up corporations.[57] For this purpose, a start-up corporation is a corporation (including predecessors) that has not conducted a material trade or business for 10 years or more. Under this safe-harbor, a valuation will be presumed reasonable if made reasonably and in good faith and evidenced by a written report issued by a qualified person (an individual with significant knowledge, experience, education and training) that takes into account the relevant factors prescribed for valuations generally. This presumption, however, will not apply if, at the time the valuation is made, the corporation reasonably anticipates that it will undergo a change in control event in the next 90 days or an initial public offering within the next 180 days.

This case is also interesting because it involved stock options that were granted (i.e., on or before January 16, 2004) before §409A was even enacted and that were exercised (i.e., during January 2006) before any proposed or final regulations were issued and during the "transition period" when several special

ferred compensation, see http://www.irs.gov/Businesses/Corporations/Nonqualified-Deferred-Compensation-Audit-Techniques-Guide-(02-2005) (Last Reviewed or Updated: April 2, 2013).

[52] *Sutardja v. U.S.*, 2013 BL 55025 (Fed. Cl. 2013).

[53] The taxpayer was a California resident and California has parallel §409A provisions. This case did not address, however, whether the taxpayer was also liable for additional income tax and penalties under California income tax law.

[54] Regs. §1.409A-1(b)(5)(iv)(B)(1).

[55] Under the final regulations, a valuation can be relied upon for a period of 12 months following the valuation date or, if earlier, the date the valuation is no longer reasonable due to a material intervening event.

[56] Regs. §1.409A-1(b)(5)(iv)(B)(2).

[57] Regs. §1.409A-1(b)(5)(iv)(B)(2)(iii).

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rules applied. The challenge by the IRS in this context has surprised many practitioners and other interested parties because many believed that the IRS would be more flexible during the transition period with respect to these issues. In this regard, however, it should be emphasized that this case involved cross motions for summary judgment, and both parties had conceded, for purposes of the motions, that the stock options were discounted stock options. The court is expected to specifically address that issue in future proceedings, and may also address whether any of the special rules during the transition period should apply. Thus, there are significant substantive issues that still must be addressed by the court in this particular case.

Release Agreements — It is quite common for employers to maintain plans and agreements providing for post-termination severance pay benefits. Unfortunately, when it comes to the release agreement requirements, many of these plans and agreements say nothing more than the post-termination benefits are ''*conditioned upon the Executive's execution and delivery to the Company of a general release of claims in a form reasonably satisfactory to the Company*.'' While this language was the standard practice prior to §409A, post-§409A agreements require more detailed release provisions in order to avoid a violation.

With respect to the execution of a release (or other post-termination employment-related action), the IRS is concerned that open-ended provisions could provide the participant with discretion over the timing of the execution of the release thereby allowing the participant to impermissibly control the calendar year in which a payment is received.[58] In response to numerous comments received by the IRS over the complexity and rigidness of its position, the IRS issued correction procedures to provide certain relief for existing arrangements that contained inadequate provisions. Under the correction procedures, existing arrangement could be fixed by a corrective amendment that provides for payment either: (i) only upon a fixed date either 60 or 90 days following the occurrence of the permissible payment event; or (ii) during a specified period not longer than 90 days following the occurrence of the permissible payment event, provided that if the specified period crosses over calendar tax years, the payment must be made in the second tax year. While the approach set forth by the IRS in its correction procedures may not be necessary in all instances, employers must pay more attention to crafting objective release provisions that contain more specificity with respect to: (i) the timing of the execution of the release; and (ii) the timing of the payment of benefits upon the release becoming final and irrevocable.

[58] Notice 2010-6, 2010-3 I.R.B. 275, *as modified by* Notice 2010-80, 2010-51 I.R.B. 853.

Post-Employment Medical Coverage — Providing post-employment medical coverage (e.g., as part of a separation agreement) has become more complicated because of the enactment of §409A and Health Care Reform. As part of the Patient Protection and Affordable Care Act (PPACA), nondiscrimination rules similar to those that apply to self-insured arrangements have been extended to insured health plans. Under the rules that apply to self-insured arrangements, if post-employment medical benefits are provided to a discriminatory group of employees (e.g., mostly highly compensated individuals), the benefits generally are taxable to the covered executives. The historical approaches for addressing this potential issue have included either using fully-insured arrangements to provide the post-employment medical coverage or having the executive pay the premiums with after-tax dollars. With the extension by PPACA of similar rules to fully-insured arrangements, it may no longer be possible to use fully-insured arrangements to avoid the nondiscrimination requirements. The IRS, DOL, and HHS, however, have suspended enforcement of the new nondiscrimination rules for insured arrangements until they issue further guidance.[59] It is not clear what options may be available in the future, which creates contract drafting issues for agreements being put in place currently. Accordingly, agreements may need to be changed in the future, but such changes may be limited by §409A or other applicable restrictions.

U.S. Subsidiary of Publicly-Traded Foreign Parent — Under §409A, the 6-month delayed payment rules apply to specified employees of a service recipient whose stock is traded on an ''established securities market'' (as defined in Treasury Regulations §1.897-1(m)). The term ''established securities market'' includes ''[a] foreign national securities exchange which is officially recognized, sanctioned or supervised by governmental authority'' (e.g., the Tokyo stock exchange). More importantly, these rules are applied on a controlled group basis and, accordingly, a U.S. subsidiary of a publicly traded foreign parent will be considered publicly traded for purposes of these rules. Accordingly, where the 6-month delayed payment rule applies, it must be written into the plan document or you will have a plan document failure.

CONCLUSION

This article has provided a summary of some of the recent tax law developments impacting executive compensation practices. This area of the law is constantly changing, and with increased scrutiny by lawmakers, regulators, shareholders and other interested parties, there will continue to be significant changes in

[59] Notice 2011-1, 2011-2 I.R.B. 259.

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the future. As a result, employers, executives and practitioners will need to continue to closely monitor this area of the law going forward.

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