TAX CONSEQUENCES OF STOCK-BASED COMPENSATION

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I. An Introduction and Overview

A. Type of Compensation—all non-qualified, executive compensation decisions involve critical choices about several issues:

1. Is the compensation to be paid in stock or cash?

2. Is the compensation to be paid and to be taxable to the executive, now or later?

3. Is the goal of the program to produce capital gain or ordinary income for the executive?

4. Does the company hope and expect to obtain a tax deduction from the compensation program?

5. Do the GAAP accounting consequences of the compensation program matter, i.e. is it important to avoid or limit a current or deferred Profit and Loss Statement compensation expense? How will the expected new stock option expense rules affect the program?

B. Type of Company—the nature of the business entity involved can have a significant impact on the design of an executive compensation program:

1. Is the employer public or private?

2. Does the employer always expect to be private or does it hope to undertake an IPO? Soon?

3. Is the employer an “S” or “C” corporation for tax purposes?

4. Is the employer a partnership, LLC or some other form of pass-through entity for tax purposes?

C. Type of Plan—non-qualified, executive compensation plans typically fall into one of the following categories:

1. Stock options
   a) Incentive Stock Options (“ISOs”)
   b) Non-Incentive Stock Options (“Non-ISOs”)

2. Restricted stock

3. SARs payable in stock or cash
4. Phantom stock
   a) SARs
   b) Other formulas
5. Employee stock purchase plans (Section 423). (All section references are to the Internal Revenue Code of 1986, as amended.)
6. Omnibus plans are designed to allow a company to use most of the above.

D. **Impact of Section 162(m)**—does any of the compensation represent “qualified performance-based compensation” so the employer’s deduction is not subject to this $1 million cap?

E. **Impact of Section 280G**—upon a change of control of the employer, will there be any “excess parachute” payments causing the employer to lose a tax deduction and the executive to be subject to a 20% excise tax?

F. **Impact of Sarbanes-Oxley Act of 2002** – should the compensation program be adjusted to take into account the Act?

II. **Stock Options**
A. **ISOs**
   1. Section 422
   2. Essential features
      a) The option must be granted pursuant to a plan which has been approved by shareholders.
      b) The plan must not be more than 10 years old.
      c) The plan must identify employees eligible to receive options—all or “key” employees is sufficient.
      d) The maximum number of shares for which options may be granted must be in the plan.
         (1) “Evergreen” share provisions are not permitted for ISOs.
         (2) New Proposed ISO Treasury Regulations seem to prohibit the use of such “evergreen” provisions in any plan that authorizes the issuance of ISOs.
         (3) An “evergreen” share provision authorizes a percentage of a future number of outstanding shares.
(4) “Net” counting of shares used for ISOs is not permitted.

e) The option may not have a term in excess of 10 years (five years in the case of a shareholder who owns directly or indirectly, 10% or more of the company stock).

f) The option price must not be less than the fair value of the stock at the time the option is granted (110% in the case of 10% shareholders).

g) A maximum of $100,000 of ISOs—based on the market value of the stock at the time of grant—may become exercisable (vest) for the first time in each calendar year.

h) The option must be non-transferable.

3. Tax consequences

a) At the time of grant, there is no income recognized.

b) At the time of exercise, there is no income recognized for purposes of the regular income tax. However, for purposes of the alternative minimum tax (“AMT”), which now has a 26% or 28% (for AMTI in excess of $175,000) rate, the option will be treated as an option which does not qualify as an ISO. There are several consequences to this rule: gain is recognized for AMT purposes; a Section 83(b) election may be needed; gain may be recognized again for regular tax purposes when the ISO stock is sold; and a prior year’s minimum tax liability credit from Section 53 may be created.

- May need to make a deliberate “disqualifying disposition” in order to avoid AMT. This may need to be done in the same calendar year in which the option is exercised.

- In other words, make the ISO into a Non-ISO.

- In “start-up” or high growth situations, the AMT may create a real tax burden. This may cause some to exercise their ISO sooner rather than later in order to reduce any AMT income. Some ISO programs allow early exercise, but restricted stock is issued as a substitute for an option vesting schedule.
c) The tax preference for capital gains may be significant:

(1) The maximum statutory rate for long-term capital gains is 15%. This applies to stock held longer than 12 months.

(2) Although being reduced pursuant to the recently enacted Jobs and Growth Tax Reconciliation Act of 2003, the maximum effective rate for ordinary income still approaches 38%.

d) As a result of the capital gains tax preference, when ISO stock is sold after satisfying the holding period rules described below, the difference between the amount realized and the option price is taxed at a much lower rate than ordinary income.

e) The company gets a deduction only if there is a “disqualifying disposition” which produces ordinary income for the optionholder. The holding period for avoiding a “disqualifying disposition” is:

(1) two years from the date of grant; and

(2) one year from the date of exercise.

f) If an option holder sells or otherwise dispose of shares acquired upon exercise of an ISO before the holding period described above is satisfied, then the option holder will recognize ordinary income at the time of the disposition in an amount equal to the lesser of :

(1) The difference between the exercise price and the fair market value of the shares at the time the option was exercised, or

(2) The difference between the exercise price and the amount realized upon disposition of the shares (unless there is a “wash sales” transaction).

(3) The option holder will then recognize long-term or short-term capital gain or loss (depending on whether the shares are held for more or less than 12 months) in an amount equal to the difference between the sale price of the shares and the fair market value of the shares on the date of exercise of the option.
g) Withholding of income or F.I.C.A. taxes are not required upon a "disqualifying disposition" even though it produces ordinary income and a compensation deduction for the company. The company is required, however, to report income from such a "disqualifying disposition" on the optionholder’s IRS Form W-2.

h) Special rules may apply to officers subject to Section 16(b) of the Securities Exchange Act of 1934.

4. Advantages

a) Except for AMT, no tax liability until ISO stock is sold

b) When sold, income taxed as capital gain

c) ISOs can include covenants not to compete, agreements not to disclose trade secrets, etc.

d) There are no antidiscrimination requirements. ISOs may be granted to a select group, and the terms of each ISO may vary.

e) Vesting schedules based on continued employment are usually included in ISOs. Performance based vesting is also sometimes used.

f) Assuming no "disqualifying disposition," the $1.0 million cap on executive compensation deductions found in Section 162(m) does not apply.

5. Disadvantages

a) AMT

b) The company does not get a deduction unless there is a "disqualifying disposition."

c) ISOs are only available to employees and may not be used with (i) consultants, (ii) outside directors or (iii) employees of partnerships or LLC’s.

(1) Most ISOs terminate 90 days following termination of employment.

(2) Current trend is to allow option to continue for up to two years after certain types of terminations, e.g., after a change of control, upon an approved retirement, etc.

(3) Be careful—after 90 days, the option is no longer an ISO.
(4) Amending outstanding “in the money” ISOs to extend the exercise period or make most other changes will disqualify them from ISO treatment. In addition, allowing a company too much discretion in the administration of an ISO program may cause problems.

d) The $100,000 vesting limitation may become a barrier, e.g., in the case of acceleration of vesting in the event of a change of control. This rule also puts an effective limitation on the size of ISOs which may be granted to any one employee.

e) The option price payable by the employee must be equal to at least 100% of the stock’s fair market value at the date of grant.

(1) Hard to determine correct option price for a private company. Need to make “good faith” effort to pick price at least equal to or greater than fair market value.

(2) When is an ISO granted? Does CEO have proper authority to grant ISO’s?

6. Other features

a) Using company stock to exercise is tax-free, if the holding period for that tendered stock has been satisfied, e.g., if ISO stock, the two-year/one-year rule.

(1) Proposed ISO Treasury Regulations provide that the extra shares acquired from exercising an ISO in this fashion have a zero basis and are deemed to be the first shares disposed of in any subsequent transaction involving any of the optionholder’s ISO shares. (Many tax advisors ignore this latter rule and allow executives to keep track of which shares are disposed of.)

(2) Shares used to exercise an ISO have a carryover basis and a “tacked” holding period. Keeping good stock certificate records and issuing “split” certificates may be very useful.

(3) Modern practice is to use an “attestation” procedure so that optionees do not actually have to deliver shares when paying the exercise price.

(4) Installment payments to exercise an ISO are allowed under applicable tax laws, but interest at the “applicable federal rate” must be charged. The option agreement should, from the time it is first issued, include authorization for these forms of exercise, even if subject to company approval.
Allowing an optionee to “exercise” an ISO by merely surrendering the option in exchange for shares equal in value to the spread between the exercise price and the value of the stock is not permitted. This will be fully taxable as ordinary income. This is an SAR, not an option.

b) The usual takeover protection is acceleration of the vesting schedule. In fact, this is essentially the only change that can be made to an outstanding ISO without causing it to lose its ISO status, subject to the $100,000 vesting rules.

c) ISO could be combined with an SAR or any other cash payment program.

d) Re-load options: the company promises to grant another option when the executive exercises the first option by using stock. The re-load option is for the number of shares used to exercise the first option and has an exercise price equal to the fair market value of the stock at the time the first option is exercised.

(1) Example: Company executive holds an option for 1,000 shares with an exercise price of $20 ($20,000 in the aggregate). If a stock-for-stock exercise is used, when the current market price of the stock is $50 per share, the executive will deliver 400 shares (400 X $50 = $20,000) and receive 1,000 option shares. This results in a net increase in the executive’s stock ownership of 600 shares worth $30,000. Under the re-load approach, upon the executive’s exercise of the first option by tendering 400 already owned shares, the executive will also receive a new stock option at the current market price ($50 per share) for 400 shares.

(2) The re-load option serves as an inducement for the executive to use the stock-for-stock exercise approach. If the executive expects the company stock to continue to appreciate, a stock-for-stock exercise is not as attractive as a cash exercise because the executive owns 400 less shares, i.e., the shares used to exercise the first option. Providing the executive with the re-load option, however, puts the executive in the best possible position to benefit from future appreciation and still use a stock-for-stock exercise on the first option, thus conserving cash.
(3) From the company’s standpoint, stock-for-stock exercises, which may be enhanced through the use of a re-load feature, may encourage share ownership and retention by executives; there is no need to sell stock to raise cash to exercise options.

(4) Please note that although the original option may be an incentive stock option, as a result of Section 1.422-5(c) of the Proposed Treasury Regulations, the re-load option may itself have to be a non-ISO.

(5) There may be other simpler, more direct approaches to encouraging stock retention involving options or parts of options which are only exercisable in the event the executive satisfies a stock ownership test.

(6) Limitations imposed by Section 162(m) may restrict the use of re-loads with non-ISOs, in order to avoid the $1.0 million cap on executive compensation deductions.

e) The company must finish a statement by January 31 of the following year to every optionee exercising an ISO which includes, among other items, date of grant, date of exercise, number of shares exercised, value of the shares, and exercise price.

(1) No requirement to send this notice to IRS.

(2) But a penalty can be assessed for failure to send these statements.

B. Non-ISOs

1. Section 83; Treas. Reg. § 1.83-7

2. Essential features

   a) The company will be entitled to a deduction for the amount of ordinary income realized by the employee upon exercise of a Non-ISO.

   b) There is no AMT problem.

   c) The option may have any term.
d) The option price may be less than 100% of the stock’s fair market value on the date of grant.

(1) Although all option grants are likely to soon result in a GAAP accounting Profit and Loss Statement compensation charge, that already accrues if there is a discount. SEC has begun carefully monitoring this issue for public companies, especially IPO situations.

(2) Blue-sky, state security laws, problems with “cheap” options.

(3) “Discounted stock options” entail tax risk. If option price is too low, the IRS may take the position that the option is deemed exercised immediately upon vesting.

e) Non-ISOs may be granted to consultants. Many public companies now offer these options to their outside directors.

f) Non-ISOs should be useable with employees of affiliated partnerships and LLC’s.

g) Shareholder approval of a plan is not required from a tax law standpoint, except for Section 162(m) qualification. However, shareholder approval is now necessary for public companies for other reasons.

(1) NYSE and NASDAQ requirements.

(2) Shareholder approval is also required in order to comply with SEC Rules.

3. Tax consequences

a) Like ISOs, no income is recognized at grant.

b) At the time a Non-ISO is exercised, there is ordinary income for the amount of the bargain realized by the optionholder.

c) The company gets a deduction for the same amount.

(1) This allows the company to “share” a non-cash tax deduction with the employee by making a “tax offset bonus.”

(2) The amount of such a bonus should be large enough to enable the employee to pay taxes due on the exercise of the Non-ISO and the cash bonus itself.
In order to avoid potential tax penalties and be entitled to the deduction, the company may have to withhold or otherwise collect taxes due upon exercise of a Non-ISO, e.g., 25% for federal income tax withholding purposes, if treated as a bonus payment (plus applicable state income tax withholding and FICA taxes).

For example, if a Non-ISO to acquire company stock results in an aggregate bargain of $100,000 and the executive holding the option is taxed at a 38% individual tax rate, this will result in a tax liability of $38,000 for the executive. If the company provides the executive with a tax bonus, sufficient in amount to pay taxes attributable both to the exercise of the Non-ISO and the receipt of the tax bonus, the company will make a cash payment of over $61,000. The executive will then be made “whole.” The company, for its part, will have a non-cash tax deduction of $100,000 from the exercise of the Non-ISO and a $61,000 tax deduction from the payment of the cash bonus (plus tax-free receipt of the option exercise price). This results in an aggregate tax benefit for the company, assuming a 35% corporate tax rate, of approximately $56,000. Since individual rates are now slightly higher than corporate, this program does impose a small, net cost on the company.

d) Even after all of the changes to the SEC Section 16(b) rules, special rules apply to officers and directors.

(1) If nothing is done, income may not be recognized until up to six months after exercise, based on the value of the stock at that later date.

(2) Within 30 days of exercise, a Section 83(b) election can be filed in order to recognize gain on the date of exercise, based on the value of the stock on that date.

(3) One example: open market purchases by an officer or director within six months prior to the exercise of option.

e) Since gain is recognized, the basis of the stock acquired is its fair market value. The holding period starts upon exercise and any further appreciation should qualify for capital gains treatment.

f) Non-ISOs may also be exercised by tendering other stock.

(1) Gain is then recognized for the full value of the “extra” shares received.
(2) That number of shares equal to the number used to exercise the option are received tax-free, with a carryover basis and “tacked” holding period.

(3) If ISO stock is used to exercise a Non-ISO, it does not constitute a “disqualifying disposition” of the ISO stock, but the two-year/one-year ISO holding period applies to the company shares received which are equal in number to those used to exercise the Non-ISO.

(4) If someone is keeping good records, it is best to provide them with two separate stock certificates. As with ISOs, modern practice is to use an “attestation” procedure rather than actual delivery.

4. Advantages

a) Non-ISOSs are essentially not subject to any special tax rules. They may have almost any features you can imagine. For private companies, the plan need not be approved by shareholders.

b) Non-ISOSs need not be exercised within any certain period following termination of employment and may have a term in excess of 10 years.

5. Disadvantages

a) Ordinary income recognized at time of exercise.

b) The company is obligated to collect taxes on that income.

(1) As with ISOs, the ability to use company stock to exercise the option will conserve the employee’s cash.

(2) Plans may also permit installment payments of the exercise price. The interest rate must be high enough to avoid a “below market loan” under Section 7872.

(3) “Tax offset bonuses”

(4) Section 162(m)’s $1.0 million cap on executive compensation deductions applies in the year a Non-ISO is exercised, not the year of its grant.
6. Other features

a) SARS payable in stock may soon replace all Non-ISOs.
   (1) Easier to exercise.
   (2) No need for “cashless exercise” programs.
   (3) Fewer shares used.

b) A “cashless exercise” program may be established. A broker and the company arrange for stock to be sold at the same time that the option is exercised in order to produce cash for the exercise and/or taxes. Such a program may raise issues under Sarbanes-Oxley Act of 2002 as to whether the public company “arranged” a loan.

c) “Stock withholding” is also used.
   (1) The company withholds shares with a fair market value equal to the employee’s tax liability.
   (2) For tax purposes, this is treated as if the shares were delivered to the employee and then sold back to the company.

d) Any ISO can be converted, after issuance and before exercise, into a Non-ISO; the reverse is not possible.

C. Other Matters

1. Accounting rules

a) Although very likely to soon change, if the option exercise price was equal to the fair market value on the date of grant, there was no compensation expense at grant or exercise. The company’s tax deduction, upon the exercise of a Non-ISO, for example, was not reflected as a reduction in tax expense but an adjustment to balance sheet equity.

b) Companies are now required to show, in a footnote, a compensation expense for option grants. This requires the company to value the options it grants. A Black-Scholes or modified version thereof is often used. So far, these footnotes do not seem to have had any impact on the valuation of the company’s stock.

c) Congress is considering a plan to require a GAAP compensation expense in order to get the tax deduction.
d) FASB is expected to soon require a compensation expense for all option grants.

2. Employees could be given a choice between ISOs or Non-ISOs. If the company is going to take into account its Non-ISO deduction, the grant of Non-ISOs should be larger. Be certain to label option agreements as either ISO or Non-ISO.

3. ISOs may be the best choice, since an ISO can always be converted into a Non-ISO. In addition, the optionholder has opportunity for capital gains at a lower tax rate.

4. Care is needed if a company is going to attempt to re-price its outstanding options.
   a) Non-ISOs can be re-priced without too much difficulty.
   b) If ISOs are re-priced, this is treated as the grant of a new option. The old, pre-repriced option, and the new, re-priced option must both be taken into account when applying the $100,000 rule on how fast ISOs may vest and become exercisable.
   c) Giving an ISO holder a choice, whether or not to accept a new lower priced option, is no longer treated as a modification of the original ISO.

5. What to do with options in the event of a merger, acquisition or other change of control? Section 280G issues are likely to arise. In order to roll over an ISO, so that it becomes an option to acquire stock of an acquiring company, it now appears that the acquiring company will have to have a shareholder approved ISO plan.

6. Employee options v. investor warrants.
   a) All options granted in connection with the performance of services are subject to the rules described above.
   b) Warrants issued to investors, and not in connection with the performance of services, do not result in any income upon exercise.

7. May be transferable for estate and gift tax planning
   a) Executive recognizes income when option exercised by donee
   b) Valuation of option for gift tax purposes is difficult. Best if donor can justify a value which is less than Black-Scholes formula.
c) IRS has ruled that unvested options cannot be gifted.

8. State Taxation

a) What happens if optionee retires to non-tax state before exercising option? Minnesota has a special rule which allows such a non-resident to avoid state taxes.

b) Safest to collect and report taxes in state in which services performed.

c) Is income for state where services were performed capped at the income that would have been recognized if the option had been exercised at the time optionee moved out of that state?

D The Future of Stock Options

1. GAAP compensation expense likely to come soon.

2. A lot of companies have already announced plans to expense options.

a) Coca Cola, GM, GE, Procter-Gamble.

b) Financial Services Forum.

c) Intel refuses.

3. How to start? FASB considers three alternatives:

a) “Clean slate” - just start for future grants.

b) Expense new grants and unvested portion of previous grants.

c) Restate all prior periods back to 1995.

4. Companies may adjust their stock option program.

a) All employee grants a thing of the past.

b) Indexed option price.

c) Longer or performance based vesting.

d) Can companies argue for lower stock price volatility and lower option values?
5. Cost verses efficiency analysis.
   a) If Block-Scholes cost of an option is $2,200 to purchase 100 shares at 55% value of $40 stock price.
   b) Stock must appreciate at least $22 per share or the option is ineffective – cost to company exceeds benefit to employee.

6. Is restricted stock or performance based stock grants the future?
   a) Executive’s benefit more like a shareholder, no leverage.
   b) GAAP expenses more certain.
   c) Uses fewer shares.
   d) More certainty of some return rather than high risk, potential high reward of stock option.
   e) Microsoft in July 2003 announced the end of stock options, replacing them with 5 year vesting restricted stock awards. A performance based vesting element may also be part of their new plan.

III. Restricted Stock

A. Usually Takes the Form of a Stock Bonus With Employment Related Restrictions
   1. Stock may not be transferred until a vesting schedule is satisfied.
   2. Stock is forfeited if the vesting schedule is not completed.
   3. Stock may be given or sold to employee at a bargain.

B. Tax Consequences
   1. Section 83
   2. Unlike ISOs and like Non-ISOS, there are very few rules.
   3. At the time of grant, no income is realized unless a Section 83(b) election is filed.
      a) Must be filed within 30 days of the stock grant.
      b) If filed, then grantee recognizes ordinary income for the fair market value of the stock at date of grant.
1. Determination of fair market value must ignore the restrictions contained in the restricted stock award agreement and any other restrictions that will expire with the mere passage of time, e.g., securities law restrictions on resale.

2. Minority or blockage discounts may be taken into account.

3. Grantee now has a tax basis equal to the fair market value of the stock at that time and any future appreciation is capital gain.

4. The company gets a compensation deduction at that time in the same amount of income recognized by the grantee.

5. Tax must be withheld or collected at the time of the Section 83(b) election.

4. If a Section 83(b) election is not filed, then ordinary income is not recognized until the restrictions lapse.

   a) Appreciation in the value of the stock during the restricted period is not capital gain.

   b) The grantee has to consider the possibility of tax law changes, and whether a current tax liability at the time of grant plus the potential for capital gains outweighs the risk of forfeiture.

   c) Although there is no ordinary income tax deduction in the event of a forfeiture following a Section 83(b) election, there is a capital loss, which may not be usable.

5. Tax basis and holding period determined when the grantee recognizes ordinary income.

6. Dividends received before the end of the restricted period and in the absence of a Section 83(b) election are deductible compensation subject to income and payroll tax withholding. They are not eligible for the new 15% tax rate on dividends.

7. “Stock withholding” and “tax offset bonuses” are sometimes used with restricted stock plans.

   a) Usually provided for only at the end of the restricted period.

   b) The stock grant may prohibit or require a Section 83(b) election.
C. Any Time Shares May Be Subject to Section 83-type Restrictions, a Section 83(b) Election Should Be Considered

1. This applies even if the stock in question was sold at its fair market value

2. Arises in start-up situations with stock provided to key employees
   a) Risk is that the key employee will be taxed at some later date when the stock has appreciated, rather than at the outset when it has a low value.
   b) There is no evidence that filing a Section 83(b) election increases the risk of audit.

D. Outside Director Restricted Stock Programs

1. Goals:
   a) To show stock ownership in the proxy statement.
   b) To avoid current taxation, i.e., no Section 83(b) election filed.

2. Design problem: satisfy test for a “substantial risk of forfeiture” under Section 83 without really creating a situation where the director will lose the stock.
   a) Deferred compensation plans, based on phantom stock units, may be a better approach since they do not require any “substantial risk of forfeiture.”
   b) Need to use some form of a “rabbi trust” with pass-through voting to create a situation where the director can show the functional equivalent of stock ownership in the company proxy. Such a program, however, increases the risk of current taxation.

E. Other Matters

1. Accounting rules
   a) A compensation expense for the value of the stock arises at the time of the stock bonus or bargain sale, but it is amortized over the restricted period.
   b) This applies whether or not a Section 83(b) election is made.
   c) This may not apply unless vesting is based on continued employment as opposed to performance based vesting.
2. Restricted stock award agreements may provide that, in the event of a
takeover, the restricted stock will immediately vest.

3. Restrictions which by their terms never lapse can be used to fix a value for
the stock.
   a) The stock is valued at “book value” and even after all restrictions
are met it can only be sold at that value because the company has a
continuing right to buy it at that value.
   b) A compensation problem arises at the time an effort is made to
remove the restrictions. It may be possible, however, under certain
circumstances to show that the removal of the restrictions is not
“compensatory” so that no income is recognized at that time. See
Treas. Reg. § 1.83-5(b) (removal of restrictions in connection with
an IPO, not compensatory).

4. If the stock must be returned upon the occurrence of an event that is
certain to occur, a “transfer” of the stock may not have taken place.
   a) If there is no “transfer,” then a Section 83(b) election cannot be
made. If there is no “transfer,” then there is no taxable event yet,
and the executive’s exposure to the recognition of ordinary income
continues to grow.
   b) Stock which must be returned for no consideration upon
termination of employment for any reason at anytime raises this
problem.

5. If the stock is being acquired with loaned funds that are nonrecourse, i.e.,
to be repaid only from the stock itself (or stock sale proceeds), there may
not be a “transfer” until loan repayments are actually made.
   a) At the time of each payment, it is as if a stock “transfer” occurs.
   b) If at that time there is a difference between the amount paid and
the stock’s fair market value, the grantee will recognize income.
   c) The issue here is whether the employee is at risk for repayment of
the loan. Will a partially recourse loan suffice?

6. Restricted stock grant with a Section 83(b) election may be very useful in
some cases.
   a) Start-up or turn around situations where there is a high degree of
certainty that the stock will appreciate in value.
b) Executive recognizes income up front on low initial value and all future appreciation is eligible for capital gains taxation to be recognized only when the executive decides to sell the stock.

c) May create need to provide funds to the executive to pay tax due as a result of the Section 83(b) election. Bonus? Loan? Loan to be forgiven in future years as services are performed? Will such a loan be respected?

IV. Phantom Stock

A. SARs: Phantom Stock for a Public Company

1. Section 83

2. Essential features

a) Company pays the difference between the fair market value of its stock at the time the SAR is granted and such fair market value at the time of exercise; subject to plan limitations, exercise is at the holder’s discretion.

b) Sometimes issued in tandem with Non-ISOs.

c) In order to avoid constructive receipt of income problems, SARs must be issued with a base value equal to fair market value of stock at time of grant.

d) May provide for payout in stock or cash, at company’s or grantee’s option.

e) Like Non-ISOs, avoids complex tax rules.

3. Tax consequences

a) Like Non-ISOs:

(1) Ordinary income for grantee at time of exercise.

(2) Compensation deduction for company, subject to Section 162(m) limits.

(3) Subject to withholding.

b) May be combined with “stock withholding.”
4. Limited SARs: SARs designed for a takeover situation
   a) Cash only SARs that spring into existence only in the event of a change of control.
   b) Not nearly as important since the adoption of the new Section 16 rules, but still provide benefit to officers who may be unable to dispose of stock because of prior open market purchases within prior six months.

5. Accounting
   a) Compensation expense must be recognized starting at grant, the expense grows as the company’s stock price increases.
   b) When the GAAP rules change for options, it is expected that SARs will be valued once at grant and expensed like options.
   c) This new accounting treatment may mean that SARs payable in stock will replace non-ISOs
      (1) Uses fewer shares.
      (2) Eliminates need to pay exercise price or borrow to do so.
      (3) Easier to administer.

B. Private Company Phantom Stock

1. A formula bonus plan
   a) Bonus may be based on anything.
   b) Examples—book value increase, net income or net income less deemed company tax expense.

2. Bonus may be paid year by year as earned or deferred
   a) Deferral may be by election made at time of phantom stock grant. Be sure to include all of the usual deferred compensation plan provisions, *i.e.*, not transferable, general creditor status, etc.
   b) Phantom stock may be “cashed in” at any time (or after a vesting requirement is satisfied) at grantee’s election.
      (1) Need to design this type of plan to avoid constructive receipt.
(2) Key is to arrange plan so that exercising phantom stock means the grantee forgoes the possibility of benefit from future appreciation.

(a) Like SAR plan.

(b) Example—only increase in book value, and not just full book value, is measure of bonus.

3. Be careful when defining the bonus
   a) How is book value defined?
   b) Who decides?
   c) What about changes in business? Accounting practices? In tax laws?

4. Tax consequences like SARs, i.e., ordinary income to grantee upon exercise (or payment, in the event of a deferred-type plan) and company deduction

5. Very popular with private companies for key, non-family employees
   a) Why give up stock that is not tradeable?
   b) Compensate key employees “as if” a shareholder.
   c) Assure employee that if company is sold, he or she gets “a piece of the action.”

C. Constructive Receipt of Income

1. Phantom stock compensation programs must be designed to avoid having an executive be deemed to be in constructive receipt of income. While this can usually be accomplished, it sometimes requires limiting flexibility on the timing and form of benefit payouts, e.g., lump sum versus installment payments.

2. A significant development may be the U.S. Tax Court decision in Martin v. Commissioner, where under the peculiar facts of that case the Tax Court allowed what, in effect, amounted to an “eve of retirement” decision regarding the form of payments under a non-qualified deferred compensation plan. The true applicability of the Martin decision remains very uncertain.
3. Option deferral programs highlight this issue.
   a) Years after a Non-ISO has been issued and vested as a result of future services, the optionee seeks to defer the gain to be recognized upon its exercise.
   b) While such deferral elections are made at least 6 months prior to “exercise,” the issue is whether this is too late and whether as a result the executive is in constructive receipt of income on account of the option.

V. Employee Stock Purchase Plans (ESPPs)

A. Not Really an Executive Plan
   1. Used recently to put as much stock as possible in friendly hands, e.g., employees
   2. Strict tax limits prevent its use as a capital accumulation device

B. Section 423
   1. Requires that all employees be eligible to participate, with defined and very limited exceptions
   2. Must provide “equal rights and privileges,” but may make shares available on the basis of a percentage of compensation
   3. Rules written in the form of stock options
      a) Many plans are actually operated as payroll deduction plans. Some companies pay “interest” on the payroll deductions account.
      b) If employee does not withdraw account balance before purchase date, then “option” is automatically exercised and stock is purchased.
      c) Price may be as low as the lesser of (i) 85% of the fair market value of the stock at the start of the payroll deduction period or (ii) 85% of the fair market value at the end of that period when the stock is purchased.
      d) Payroll deduction period is usually three, six, nine or 12 months, but may be as long as 27 months for plans with the lowest possible pricing rule.
4. Essential features
   a) Requires a shareholder approved plan that specifies the maximum number of shares that can be issued and the definition of employees eligible to participate.
   b) 5% shareholders excluded
   c) $25,000 per year maximum
   d) May exclude some employees
      (1) Less than two years of service
      (2) Works less than 20 hours per week
      (3) Works less than five months per year
      (4) Highly compensated (within meaning of Section 414(q))

5. Multiple Purchase Periods and Dates
   a) A much more complex form of ESPP involves purchase periods that run as long as two years with stock acquired every six months. Such a plan allows employees to continue to use a purchase price equal to 85% of the fair market value of the stock two years ago. The complexity arises from special provisions that allow new employees or participants to join every six months, although their purchase period starts only then, and they cannot use a price from prior periods. When fully implemented, different groups of employees may be buying stock at four different prices.
   b) Another new form of ESPP, which is also more complex, merely allows employees who were not eligible or did not join on the first day of a purchase period to join later, using the date of their first participation for determining their purchase price.
   c) If interested in extreme complexity, the foregoing concepts could be combined creating a plan with long purchase periods and regular opportunities to join.

6. Tax consequences
   a) Amounts deducted for the payroll deduction account are on an “after tax basis.”
   b) No income to participant at time shares purchased, even if purchased at 15% or greater discount.
c) Income recognized at time shares are sold.

   (1) Two-year/one-year holding period like ISOs.

   (2) If stock is sold after satisfaction of holding period, then 15% bargain at time of purchase is ordinary income, but company gets no deduction. Use price at start of purchase period for this computation.

   (3) If stock is sold after satisfaction of holding period, then balance of gain, if any, is capital gain.

   (4) If stock is sold before satisfaction of holding period, then bargain element as of date of purchase is ordinary income, and company does get a deduction.

   (5) If stock is sold before satisfaction of holding period, then balance of gain, if any, is long or short-term capital gain, depending on holding period.

C. Other Matters

1. Many companies have found that “out-sourcing” the administration of these plans is efficient.

2. Be careful that all eligible employees in fact have a right to participate.
   a) “Temporary employees” may be a useful concept for internal budgeting which has no relevance under Section 423.
   b) If a company fails to properly administer its plan, applicable Treasury Regulations provide that no one gets the benefit of Section 423.
   c) Fortunately, there is almost no evidence that the IRS audits these plans for compliance with Section 423.

3. As with ISOs, companies are obligated to send statements by January 31, which includes basic information relating to stock acquired in the prior year.

VI. Partnership or LLC Compensation Programs

A. Options to Acquire Partnership or LLC Interests Are Generally Not a Good Idea

1. ISO’s not possible here, so all such options result in ordinary income at time of exercise
2. Under current Treasury Regulations, the exercise of an in-the-money option may cause the pre-existing members of a partnership or LLC to recognize gain at the time of the exercise

   a) The partnership or LLC enjoys a compensation deduction as a result of the option exercise, and this deduction could be specially allocated to the pre-existing members

   b) This deduction may not always match the income to be recognized and even if it does, the effect is to eliminate the true benefit of the compensation deduction

3. New member will recognize gain if the new member acquires any interest in appreciation in the value of the partnership or LLC that arose prior to the exercise of the option. Gain will not be recognized if the new member’s capital account is only credited with the amount paid upon exercise of the option.

B. Use of “Profits” Interest May Have More Appeal

1. A profits interest gives the holder only an interest in profits and future appreciation

   a) It has no value at time of grant

   b) Under Rev. Proc. 93-29 and Rev. Proc. 2001-43, the grant of a profits interest, even in connection with the performance of services, has no tax consequences

2. A profits interest given at formation allows the holder to share in all future appreciation and income

   a) Better than holding a mere option

   b) Rights to profits interest could be subject to restriction and forfeiture with a vesting schedule

   c) Section 83(b) election should be made at time of grant

3. Does not result in income to other partners or members

4. Does not produce a compensation tax deduction for employer

5. Multiple grants of profits interests over time require complex tax accounting and periodic revaluation of partnership assets
C. An Employee Who Becomes a Partner or Member Ceases to be an Employee for Tax Purposes

1. All of that partner’s income becomes subject to the self-employment tax, which is, in effect, equal to the employee plus employer share of FICA taxes

2. Income is not subject to withholding but does require estimated tax payments by partner

3. Partners and members are subject to various limitations on certain employer benefit programs, e.g., health insurance benefit becomes taxable income

VII. Cap on Deduction For Executive Pay Over One Million Dollars

A. Section 162(m)

1. Section 162(m) limits corporate deductions to $1 million per year for compensation paid to “covered employees”

   a) Covered employees are the CEO and each of the four other most highly-compensated executives of public companies whose compensation must be disclosed under the rules of the Securities and Exchange Commission.

   b) “Publicly held” means that the company’s common stock is required to be registered under Section 12 of the Securities Exchange Act of 1934. This would include all companies listed on one of the major stock exchanges or reported on the NASDAQ National Market System.

B. Definition of Compensation

1. This limitation on deductibility of executive compensation applies in the year in which the deduction would otherwise be taken.

2. In the case of a non-incentive stock option, since the corporate deduction is taken in the year in which the option is exercised, it is in that year, not the year of grant, that the $1 million limitation may apply. However, if in the year such an option is exercised the optionee is not a “covered employee,” then Section 162(m) cap will not apply.

3. Apparently since no corporate deduction is created upon the grant or exercise of an incentive stock option, the $1 million cap will have no impact on this form of compensation. However, the cap may come into play when a corporate deduction is created as a result of a “disqualifying disposition” of such stock. Furthermore, a $100,000 per year vesting rule
continues to limit the maximum amount of incentive stock options which can be granted to an executive.

4. **Exclusions.** The definition of compensation for purposes of Section 162(m) excludes:

   a) fringe benefits that are excludable from gross income (*e.g.* employer provided health insurance, qualified employee discounts, etc.);

   b) payments to tax qualified retirement plans; and

   c) “qualified” performance-based compensation. Qualified performance-based compensation includes commission income and other performance-based income that meets certain independent director and shareholder approval requirements.

**C. Commission Income**

1. The cap on deductions for executive pay does not apply to any portion of executive compensation that is paid on a commission basis solely on account of income, *i.e.*, sales, generated directly by the individual performance of the executive.

2. Commission income for purposes of this rule does not, however, include broad performance standards which are dependent upon company performance or performance of a business unit.

**D. Performance-Based Compensation**

1. The compensation must be paid solely on account of achieving one or more performance goals.

   a) The performance goals must not include any discretionary elements.

   b) In the case of stock option plans, however, the outside directors may retain discretion as to the exact number of options granted to an executive.

2. The performance goals must be established by a compensation committee of the company’s board of directors consisting of two or more outside directors.

   a) A director is considered an outside director only if he or she:

      (1) is not a current employee,
(2) was not an officer of the corporation (or related entities) at any time;

(3) is not currently serving as a consultant to the corporation or otherwise, directly or indirectly, receiving remuneration from the corporation in any capacity other than as a director; and

(4) is not a former employee who is receiving compensation for prior services, other than pursuant to a tax-qualified pension plan. Under this last requirement, former employees who are receiving deferred compensation payments would be excluded from serving as outside directors.

b) These rules are different than the old SEC’s Rule 16b-3 “disinterested director” requirements.

c) A member of the company’s compensation committee should be removed if he or she does not meet the foregoing definition and as a result does not qualify as an outside director. Alternatively, the compensation committee could establish a sub-committee that includes only outside directors. Please note that such a sub-committee must administer the entire plan, not just grants to those executives actually covered by Section 162(m).

3. Prior to any payments thereunder, the material terms of the plan, including performance goals, must have been approved by a majority of the shareholders, in a separate vote, after adequate disclosure.

a) Generally shareholder approval must include:

(1) approval of the specific terms of the plan including the class of executives to which it applies;

(2) in the case of stock option plans, the option price or formula under which the price is determined; and

(3) in the case of stock option plans, the maximum number of shares subject to option that can be awarded under the plan to any one executive.

b) It is expected that at a minimum shareholders will be aware of, and approve, the general performance goals on which the performance compensation is based and the maximum amount which could be paid to executives if such performance goals are met. It will not be adequate if the shareholders are merely informed that an executive will be awarded a bonus of a certain amount if that executive meets
certain performance goals to be established in the future by the compensation committee.

(1) Shareholders do not have to approve specific performance goals; they may be established by the committee of outside directors.

(2) Shareholders must, however, approve a list of business criteria upon which such performance goals are based, e.g. earnings per share, and the maximum amount that can be paid to any one participant under the plan.

(3) A plan of this type requires re-approval by shareholders every 5 years.

(4) An alternative to the foregoing is shareholder approval of a specific bonus formula. While such a plan does not require approval of a cap on compensation, it does require new shareholder approval if any changes are made in the formula.

c) In some cases, required shareholder disclosure may exceed current SEC requirements and result in divulging confidential information to competitors.

d) If there are material changes to the plan, then additional shareholder approval may be required.

4. The committee of outside directors must certify that the performance goals, and any other material terms, were in fact satisfied prior to any payments.

5. Stock options and stock appreciation rights may qualify as performance-based compensation, even though their vesting and/or exercisability are not tied to performance goals, because the value of the option or right is based on company performance as measured by changes in the price of its stock.

a) As described above, however, the shareholders will have to approve the maximum number of options or rights which can be awarded to any one executive. Presumably this ceiling could be expressed as an annual or multi-year maximum, e.g. no more than “X” shares per year or no more than “Y” shares over a “Z” period of time.

b) Fortunately, satisfaction of the shareholder approval requirement does not require shareholder approval of specific grants.
6. Restricted stock programs, because they are not inherently performance based, do not automatically qualify for the foregoing performance-based compensation exception.
   a) Even stock-based compensation is not treated as performance based if it is dependent on factors other than stock price/corporate performance.
   b) Options that are granted with an exercise price that is less than the fair market value of the stock at the time of the grant do not automatically meet the requirements for this exception.

7. “Pool Plans” are a popular variation on the foregoing rules designed to allow companies to pay performance-based compensation without needing to rely on a restrictive formula.
   a) A precise formula is designed to create a pool from which bonuses are paid. There need not be a cap on the size of the pool resulting from the application of the formula.
   b) Participants and maximum percentages that each may be paid from the pool are listed.
   c) The percentages must not exceed 100% so that the payment of a bonus to any one participant does not affect the amount available to pay any other participant.
   d) The compensation committee administering the plan retains discretion, “negative discretion,” to pay less than the maximum amount provided for in the plan.
   e) All of the foregoing is approved by shareholders.
   f) While the size of the pool and each participant’s maximum award therefrom is purely quantitative, the compensation committee in the exercise of its negative discretion may take into account subjective and discretionary factors.

VIII. Golden Parachutes—Section 280G

A. General—Section 280G generally provides that any payment in the nature of compensation made by any party to certain “disqualified individuals” which is contingent on a change in ownership or control of a company constitutes a “parachute payment.”
**B. Excess Parachute Payment**—If such “parachute payments” to a disqualified individual equal or exceed 3 times such individual’s “base amount”, the excess of the “parachute payments” over 1 times such individual’s base amount constitute “excess parachute payments.”

1. Excess parachute payments are subject to a 20% excise tax payable by the disqualified individual.

2. In addition, the payor of such excess parachute payments would not be entitled to a deduction therefor.

3. The base amount is average annual compensation over the five taxable years preceding the taxable year in which a change in ownership or control occurs. Example—change of control closes in 2001, the base amount is calculated for a 5 year period ending in 2000.

4. Disqualified individuals are generally defined to include officers, shareholders (but only if they hold at least 1% of the company’s stock) and highly compensated individuals.

5. Recent final Treasury Regulations published by the Treasury Department in August 2003 provide limited additional guidance on these and other key defined terms.

**C. Contingent on Change**—To be a parachute payment, the payment must be contingent on a change in ownership or effective control of the company.

1. In general, a payment is to be treated as contingent on a change in ownership or control, if such payment would not, in fact, have been made to the disqualified individual, had no change in ownership or control occurred.

2. As a result, payments nominally contingent only upon termination of employment will be considered contingent on a change in ownership or control if termination occurs as a result of such a change.

   a) A payment is generally treated as contingent on a change in ownership or control if the payment is contingent on an event that is closely associated with such a change.

   b) All payments under an employment contract entered into, or amended in a significant respect, within one year before or after a change in ownership or control are presumed contingent upon such a change, unless the contrary is established by clear and convincing evidence.

   c) In fact all payments made within one year of a change of control are presumed to be on account of that change.
3. Example—assume that a sale of Company XYZ takes place in 2001 and that Executive A’s base amount is $100,000 computed as his average annual compensation for the period 1996-2000. Assume further that a payment totalling $400,000, which is contingent on a change in control, is made to Executive A by Company XYZ on the date of the sale. Parachute payments total $400,000, and the parachute provisions apply because $400,000 equals or exceeds $300,000 (three times the $100,000 base amount).

a) Excess parachute payments are potentially as much as $300,000 ($400,000 minus the $100,000 base amount), and that amount would be subject to the 20% excise tax and not be deductible by Company XYZ.

b) If parachute payments totalled only $299,999, there would be no 20% excise tax or loss of deduction because the payments would not equal or exceed the $300,000 threshold.

c) A case of “more is less” is possible: Executive and the company are both better off with parachute payments of only $299,999 than $300,000 in this example.

D. Special Rules

1. A parachute payment does not include any payment from certain qualified retirement plans.

2. Payments in the nature of compensation which may be subject to the golden parachute rules include all payments which arise out of an employment relationship or are associated with the performance or non-performance of services, including bonuses and payments under a covenant not to compete.

3. In an interesting provision, which some have suggested may be a “loophole,” the Treasury Regulations provide that a payment will not be treated as a parachute payment, if the payment is made under an agreement entered into after the change. (We believe, however, the Internal Revenue Service would limit widespread use of this provision by attempting to prove that an informal pre-change of control agreement had been reached.)

4. A payment may be treated as a parachute payment if the change of control accelerates the time at which the payment is to be made. In that case, the portion of the payment that is treated as a parachute payment is the amount by which the accelerated payment exceeds the present value of the payment absent the acceleration.
5. Any amount which an executive establishes by clear and convincing evidence (a very rigorous standard) is **reasonable compensation** for personal services actually rendered before the date of the change of control may reduce the total amount of payments subject to the 20% excise tax and the disallowed deduction rules. However, with respect to reasonable compensation for prior services, such compensation is first offset against the executive’s base amount.

   a) Returning to the first example set forth above, assume once again that Executive A’s base amount is $100,000 and that $400,000 of parachute payments are being made on the date of sale of Company XYZ. Under the normal rules set forth above, excess parachute payments subject to the 20% excise tax and the disallowed deduction rules are $300,000.

   b) However, if Executive A establishes by clear and convincing evidence that reasonable compensation for prior services, after taking into account actual compensation received by Executive A in those prior years, is $150,000, then the excess parachute payments may be reduced as follows: $400,000 minus reasonable compensation for prior services, $150,000, minus $100,000, the base amount equals $250,000.

6. Any amount which an executive establishes by clear and convincing evidence is reasonable compensation for personal **services to be rendered on or after the date of the change** of control is excluded in determining whether the 20% excise tax and disallowed deduction rules apply.

   a) The legislative history concerning this provision provides that reasonable compensation for services to be rendered in the future includes payments to an executive as damages for breach of contract by the acquiring company.

   b) Certain requirements must be met, however, to take advantage of this rule including (1) the damages for breach of that employment contract may not exceed the compensation the individual would have received if the individual continued to perform services for the acquiring corporation, (2) the executive must demonstrate by clear and convincing evidence that the payments were received because an offer to work by the executive was made and rejected by the acquiring company, and (3) any damages must be mitigated, *i.e.* reduced by compensation the executive receives from other employment, which he is obligated to seek.

   c) An open question here is whether the executive has an affirmative obligation to seek alternate employment for purposes of applying the mitigation rule.
d) Using the same example set forth above, parachute payments are still assumed to be $400,000. However, the parachute provisions of the Code would not apply if Executive A establishes by clear and convincing evidence that at least $100,00—the amount by which total parachute payments of $400,000 exceed three times the $100,000 base amount—is reasonable compensation for personal services to be rendered in the future.

E. Stock Options and Restricted Stock

1. If vesting of a non-incentive stock option is accelerated in the event of a change of control, only a portion of the resulting benefit is treated as a parachute payment.

2. The portion treated as a parachute payment is (i) the amount by which the current value of the accelerated, vested stock option exceeds the present discounted value of the stock on the original vesting date, plus (ii) an amount reflecting the lapse of the obligation to continue to perform services.

a) For purposes of making this computation, the value of the stock and the option are treated as being the same. Based on the final Treasury Regulations, the value of the stock option for purposes of this computation must, in effect, take into account the option privilege and is likely to be equal to a Black-Scholes type value. Previously the option was simply equal to the bargain element of the option (current stock value less option price) as of the date of the change.

b) The present value of the stock option on the original vesting date is then determined by using that current value and a discount rate equal to 120% of the “applicable federal rate” (a rate determined pursuant to the Code) as in effect as of the closing date for the change of control.

c) Generally, the amount reflecting the lapse of the obligation to perform future services to the original vesting date depends on all the facts and circumstances, but in no event shall it be less than 1% of the amount of the accelerated payment (the current stock value) multiplied by the number of full months between the date of change and the original vesting date.

d) Under limited circumstances, an option may be re-valued (reduced in value) based on changes in the 18-month period following a change of control.
3. As an example, assume the current value of Executive A’s accelerated stock option, which is being rolled over to become an equivalent option of the acquiring company, is $500,000 (i.e., the Black-Scholes value of the option is that amount), and the present value of that stock option on the original vesting date (assume that is 25 months after the change of control) is the current value ($500,000) discounted from the original vesting date to the accelerated date (i.e., $400,000). The lapse of the obligation to perform future services for 25 months is not less than 1% times 25 months times $500,000 (i.e., $125,000). The parachute payment in the example is (i) $500,000-$400,000 plus (ii) $125,000, equals $225,000.

a) This is much less than the full bargain element of the option.

b) As a result, the executive would probably be interested in reducing cash parachute payments by $225,000 in order to retain an option which is really worth $500,000.

4. Under the most recent version of the applicable regulations, ISO’s are treated in the same fashion as non-ISO’s.

5. The same approach described above for non-incentive stock options is also used for the acceleration of restricted stock grants.

F. Exemption For “S” and Privately Held Corporations

1. Special rules in the Code provide, in effect, that if a change of control occurs with respect to a corporation eligible to be an “S” corporation (whether or not it so elected and without regard to the prohibition on nonresident alien shareholders), then the parachute provisions do not apply.

2. In addition, if the target company has no stock which is readily tradeable on an established securities market or otherwise, then the parachute provisions will not apply if an additional shareholder approval requirement is satisfied:

a) All disinterested shareholders, i.e., those not receiving parachute payments or affiliated with those who do, holding more than 75% of the voting power of all of the stock of the company in question must specifically approve the parachute payments.

b) Adequate disclosure to all shareholders of all material facts concerning the proposed parachute payments must be made.

c) The receipt of the payments must be contingent on the shareholder approval. This may require older agreements to be modified and subjected to such approval.
G. Parachute Agreements

1. Agreements often provide for payments only after two conditions are satisfied.
   a) A change of control, as defined in the agreement, must take place.
   b) Within a defined period of time, such as two years, the executive must be fired for other than cause or quit for “good reason.”
      (1) Good reason typically refers to reduction in salary or duties, re-location, etc.
      (2) Most agreements do not allow the executive to quit for any reason and receive the parachute payments.

2. Section 280G provisions in these agreements seem to fall into one of three categories.
   a) Caps—payments are capped at the amount that would not trigger the special excise tax or loss of deduction.
      (1) If this approach is used the agreement should establish a mechanism for determining which parachute payments are reduced.
      (2) Under many circumstances, as described above, the executive would choose to forgo cash in exchange for the vesting of more stock options.
   b) Gross-Up—payments are made and if they result in a parachute tax, extra payments are made to cover that tax liability.
      (1) Since the extra payment is itself a parachute payment subject to the excise tax, the gross-up should take this into account.
      (2) Very expensive to the company, since the payments are not deductible. If excess parachute payments are $300,000, the excise tax is 20% of that amount, $60,000. A gross-up payment would be approximately $143,000. None of the foregoing is deductible by the company.
c) Cut-Back—payments are made without a gross-up, but they are reduced if doing so would increase the net after tax return to the executive.

(1) See “less is more” example above.

(2) Not relevant if parachute payments are far in excess of base amount.

3. Acquiring companies will often go to great lengths to avoid the impact of Section 280G and especially the cost of gross-up payments, if applicable.

a) New, retention agreements entered into only after the change of control.

b) New, generous employment or consulting agreements entered into before or after the change of control but hopefully qualifying as reasonable compensation for future services.

c) Accelerate bonus payments in to a year prior to the year of an actual change of control in order to increase executive’s base amount.

IX. Sarbanes-Oxley Act of 2002

A. Effective July 30, 2002

B. Significant Changes

1. Accountants and auditors affected

2. Corporate responsibility changes including CEO/CFO certifications of financial records

3. Enhanced disclosure rules

4. Corporate and criminal fraud and liability rules

5. Lawyer professional responsibility rules

6. Stock analyst conflict of interest rules

7. Whistleblower protection
C. Section 402—Ban on Loans to Directors and Executive Officers

1. Complete ban on all direct and indirect loans
   a) Definition of “executive officer (or equivalent thereof)” unclear
   b) Scope of indirect loan ban unclear

2. Existing loans grandfathered, as long as there is no “material modification” or any “renewal”

3. Limited exception for ordinary course of business loans at market rates by banks, broker-dealers and others in the business
   a) Must be made in ordinary course of a consumer credit business
   b) Generally made available to the public
   c) On terms no more favorable than those offered to general public

4. Scope of Section 402 ban on loans unclear
   a) Relocation or other short-term loans?
   b) Business credit cards?
   c) Are broker loans in connection with same day option exercise sales indirect loans from the company? SARs payable in stock avoids this issue.
   d) Split dollar life insurance programs?
   e) Prohibits installment payment of option exercise price

D. Section 304—Forfeiture of Certain Bonuses and Profits and Other Limitations

1. CEO/CFO bonuses, incentive-based or equity-based compensation, and profits from sales of company stock must be returned
   a) A “clawback” rule
   b) Terms not defined, but may cover, at the very least, all Section 162(m) qualified performance based compensation.
2. Compensation earned during the 12 month period following the first public issuance or filing of financial statements that are subsequently restated
   a) May in effect have retroactive effect
   b) Restatement after July 30, 2002 could result in clawback of compensation earned before date of enactment.
3. Restatement must be due to “material noncompliance of the issuer, or a result of misconduct, with any financial reporting requirement . . . .”
   a) Misconduct of anyone or just CEO/CFO?
   b) SEC has authority to exempt any person from this rule.
4. Section 1103 of Act gives the SEC authority to seek a Court Order requiring a 45-day escrow of any extraordinary payments, including compensation, that a public company under investigation proposes to make. The escrow period may be extended under various circumstances.
5. Directors and officers of public companies are prohibited from buying or selling any company stock, acquired in connection with their employment for the company, during any qualified retirement plan “blackout” period.
   a) “Blackout” period is 3 or more days when at least 50% of qualified retirement plan participants cannot sell any company stock.
   b) Company must provide notice of “blackout” periods.