University of Mississippi

eGrove

Touche Ross Publications

Deloitte Collection

1963

Deferred compensation and stock options

Lawrence J. Scully

Follow this and additional works at: https://egrove.olemiss.edu/dl_tr

Part of the Accounting Commons, and the Taxation Commons

Recommended Citation
Quarterly, Vol. 09, no. 1 (1963, March), p. 16-21

This Article is brought to you for free and open access by the Deloitte Collection at eGrove. It has been accepted for inclusion in Touche Ross Publications by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

Deferred Compensation and Stock Options

This article is based on a talk which the author gave before the 1962 University of Pennsylvania Tax Conference. It appeared in substantially the same form in TAXES—The Tax Magazine, January 1963. Mr. Scully cautions the reader that the President has asked congress to exact legislation which would substantially affect advantages of restricted stock options to employees.

CONSIDER FOR A FEW MINUTES, if you will, that you are a member of the Board of Directors of a medium-sized corporation. In such capacity you are confronted with the following problem. John Jones, one of the company's key executives, is currently earning $40,000 a year base salary, plus a bonus computed on a percentage of net income which has varied between $1,000 and $9,000 over the last five years. Although John has earned a good salary for the last ten years, he can look forward to retiring in 15 years with post-retirement income of only $12,000 a year. Ten thousand dollars a year of this $12,000 annual post-retirment income will come from a company-sponsored qualified pension plan. The Board of Directors has decided that if they are to retain the services of John Jones until retirement they must increase his compensation. You, as a member of the Board of Directors, have been asked to investigate two of the possible ways in which this increase in compensation may be granted to John. The two methods are a nonqualified deferred compensation plan[1] and a stock option plan.[2] Both of these plans are to be investigated with a view toward increasing John's after-tax earnings, assisting him in creating an estate, and at the same time enabling the corporation to claim a deduction for amounts paid. Your knowledge of the company's qualified deferred compensation plan reveals that John's benefits under the plan cannot be substantially increased without, at the same time, increasing the benefits to all other employees covered by the plan. This would be too costly to the company and is not to be considered.

Therefore, if a deferred compensation plan is to be utilized, it will of necessity be a nonqualified plan. A nonqualified plan may have one of several objectives. It may attempt to defer part of John's current earnings and spread them over a period of years while he is still employed, or it may defer current income until after his retirement. The first of these two objectives is incorporated into many executive profit-sharing plans. Under such plans an executive's bonus is computed based on current income of the corporation, but only a fraction is paid out in the current year. The remainder is prorated over the subsequent three to five years and generally is payable only if the executive is still employed by the corporation. This type of profit-sharing plan would serve a dual purpose in John's case. Increases in his compensation would be geared to increases in profits of the corporation. The corporation would obtain a deduction as the amounts were actually paid[3] and John would pick them up as income only in the years they were actually received. Spreading the payments over a period of years would be of a further advantage to John in that his earnings from one year to the next would tend to be level from one year to the

[1] IRC Sec. 404(a)(5).

[2] IRC Sec. 421.

[3] See footnote 1 and Reg. 1.404(a)-12.

Lawrence J. Scully

Lawrence J. Scully, partner in the Philadelphia Office, was born in Bucks County, Pa., and is a graduate of Temple University. He has been active in state and national accounting organizations, is a past President of the Pennsylvania Institute of Certified Public Accountants, and is currently a Council member of both the Pennsylvania Institute and the American Institute. A member of the Advisory Committee of the University of Pennsylvania Tax Conference, he is also a member of the Advisory Committee that developed the curriculum for the Fifth Year in Accounting at the University of Pennsylvania. Mr. Scully is married and has three children.

next. Sharp fluctuations in any one year's bonus due to changes in corporate earnings would not be influenced by the graduated personal income tax rates as much as if he had received a large bonus in the year earned. Thus, his after tax earnings would probably be increased. A side benefit to the corporation would be that John would forfeit his remaining bonus payments if he left the employ of the company prior to retirement.

As an alternative or an additional plan for granting John an increase in compensation, a nonqualified plan may be devised which will defer current income to post-retirement years. At that time, based on current estimates of his retirement income, John's tax rates will be substantially lower than they are at the present time.

Knowing that these two objectives can be obtained through non deferred compensation plans is only part of the answer, however. You must be prepared to convince John that the compensation plan finally proposed to him will be best for him in the long run, considering not only the income tax factors but also the security aspects of certainty of payment after retirement.

A nonqualified deferred compensation plan may be based upon a contractual promise by the corporation to pay the funds to John at some time in the future, or it may be financed by current payments to a fund in which John presently has either a forfeitable or nonforfeitable right. This brings out some basic distinctions among nonqualified plans. A plan may be:

(1) Unfunded in which the employee has a forfeitable right;

(2) Unfunded in which the employee has a nonforfeitable right;

(3) Funded in which the employee has a nonforfeitable right;

(4) Funded in which the employee has a forfeitable right.

Each of these variations has attributes which may be

attractive or unattractive to one of the parties to the transaction. Before discussing the attributes of these various plans, it is appropriate to emphasize the distinction between a funded and an unfunded plan and between forfeitable rights and nonforfeitable rights. Generally, the funding of a plan signifies not only a segregation of assets but also the granting of substantial present rights in the assets to the employee.[4] This is to be distinguished from a mere segregation of assets by the employer as a source of eventual disposition to the employee and in which the employee has no present rights. If the employee does not have any interest in these assets until payment is made, the segregation is not considered a funding. An employee's rights under a plan will be considered to be forfeitable if there are substantial conditions precedent to his having an unrestricted right to the assets other than the passage of time until he retires or reaches a given age.[5]

Characteristics of Four Variations

Your examination of the four variations in deferred compensation plans mentioned above indicates they have the following characteristics.

An unfunded plan in which John's rights are forfeitable until age 65 or retirement and in which his rights are conditioned upon his continuing as a corporate officer would result in no taxable income to John until he actually receives payments from the plan.[6] Until he receives the money, John has only an unsecured interest under a contract which is not considered cash or its equivalent. Under such a plan the corporation would be allowed a deduction in the year that the amounts are actually paid.

An unfunded plan in which John's rights are nonforfeitable, specifying income to be paid to John upon reaching age 65 or retirement, would result in the same tax effects to John and to the corporation as under the previous plan. That is, taxable income would be recognized by John in the year cash is received and a deduction would be allowed to the corporation in the year actually paid.

The main difference between these two plans lies in a nontax factor affecting the corporation. In the first plan the forfeiture clause serves as a deterrent to John in leaving the corporation prior to retirement. Under the second plan, John could leave at any time and still obtain the benefits upon reaching age 65. At one time the forfeiture clause was considered essential to insure the employee deferral of the income until actual cash receipt. However, since the issuance of Revenue Ruling 60-31, many authorities believe the forfeiture clause is now unnecessary. This belief is based on two examples given in the Revenue Ruling. Although both examples effectively deferred the income to the employee until actually received, one employs a forfeiture clause while the other contains no forfeiture clause.

Although both of these plans provide the desired effect from a tax standpoint, you are concerned that John will ask for more assurance of eventual payment than the mere contractual obligation of the corporation. To be realistic such an obligation is only as good as the corporation will be at sometime 15 to 20 years in the future. The logical step to take to surmount this objection would be to fund the plan, thereby giving John either a forfeitable or nonforfeitable right in assets segregated under the plan. However, the adverse tax effects of both of these plans, as discussed below, effectively rule them out of consideration.

A funded plan in which John has nonforfeitable rights would result in taxable income to him in the year in which amounts were paid into the fund.[7] Even though John would have to wait until age 65 or retirement before he could receive any payments, the doctrine of economic benefit could be used to find the current additions to the fund taxable to him. Current payments by the corporation into the fund would result in current deductions under Section 404(a) if the requirements of Section 162 are met.

A funded plan in which John has forfeitable rights at the time contributions are made would result in no taxable income to him until he actually receives the cash distributions from the fund. However, the payments into the fund by the corporation will never be deductible by the corporation since John's interest in the fund is forfeitable. This disallowance is specifically stated in Section 404(a)(5).

It should be noted that two principles override any nonqualified deferred compensation plan. First, John's over-all compensation must be reasonable.[8] Second, there is the possibility that additional income might be taxed to him currently under either the economic benefit or constructive receipt doctrine.

Generally, Section 404(a)(5) allows the corporation to deduct deferred compensation payments to John. A

[4] Rev. Rul. 60-31, 1960-1 CB 174.

[5] See footnote 4.

[6] See footnote 4.

[7] Rev. Rul. 57-37, 1957-1 CB 18 as modified by Rev. Rul. 57-528, 1957-2 CB 263.

[8] IRC Sec. 162.

limiting factor on this authority is the requirement of Section 404(a) that any amounts deducted, even under a nonqualified plan, must meet the requirements of Section 162 as being ordinary and necessary business expenses. In this manner the reasonableness of John's over-all compensation may become a limiting factor.

The deferral of an employee's income under certain nonqualified deferred compensation plans has been successfully attacked by the Internal Revenue Service on either the constructive receipt doctrine or the economic benefit doctrine. The doctrine of constructive receipt has been applied to situations in which the employee could have received the items of income currently, but through his own volition or special arrangement has chosen to defer the actual receipt of the money until a later time. For instance, the substitution of a nonqualified deferred compensation plan for John's current bonus might be taxed to John currently if the plan benefited only John and it did not contain substantial conditions precedent to final vesting in him. The economic benefit doctrine has been used to destroy the advantages to an employee under a plan that grants the employee unrestricted rights in property which have a realizable market value.

Stock-Option Plans

The second alternative which you are to investigate with a view to increasing John Jones' compensation is a stock-option plan. Your investigation of stock options reveals that if the technical requirements of Section 421 are met, not only may a portion of John's income be deferred but also a portion of it may be converted into capital gains.

There are three types of stock options to be considered, each of which affords a different tax treatment to the person receiving the option. The three types are a 95 per cent restricted stock option, an 85 per cent restricted stock option, and a nonrestricted stock option. By definition a restricted stock option must be granted by the issuing corporation or its subsidiary to one of its employees.[9] The option must run for not more than ten years;[10] it must be nontransferable except at death;[11] and its price must be at least 85 per cent of the fair market value of the stock on the date the option is granted.[12] Further, the employee may not own more than 10 per cent of the employer's stock unless certain additional factors are present.[13]

Both 85 per cent restricted stock options and 95 per cent restricted stock options will serve to defer income to John as well as in some cases grant him capital gains treatment on portions of the income. In order to qualify for these two tax benefits, the option must be exercised by John during the period of his employment or within 90 days thereafter.[14] Also, he must not dispose of the stock so acquired within two years of the date the option was granted to him nor within six months of the date the stock was transferred to him as a result of exercising the option.[15]

Assuming the formal requirements are fulfilled, an option to buy stock at a price equal to 95 per cent of the fair market value of the stock on the day the option is granted will have the following tax effects on John. He will recognize no taxable income at the time the option is granted not at the time the option is exercised. The only income he will recognize will be capital gains and then only if the stock is sold during his lifetime.[16]

If the option price for the restricted stock option is between 85 per cent and 95 per cent of the fair market value of the stock on the day the option is granted, John will also recognize no income at the time the option is granted nor at the time the option is exercised.[17] Income will be deferred until the stock is disposed of by sale or by other transfer. At the time of sale or transfer, gain will be split between ordinary income and capital gain. Ordinary income will be measured by the difference between the option price and the lesser of the value of the stock at the time the option was granted or the value of the stock at the time of sale or transfer.[18] Any additional gain which is realized will be taxed as capital gain.[19]

No deduction will accrue to the corporation as a result of either of these restricted stock options.

If John dies without exercising the restricted stock options, they will be included in his gross estate for federal estate tax purposes at their fair market value. The basis of stock which the estate or beneficiary acquires as a result of exercising the options held by John at his death will be adjusted to reflect the value of the option included in the estate tax return.

If the requirements of a restricted stock option are

---

[9] IRC Sec. 421(d)(1).
[10] IRC Sec. 421(d)(1)(D).
[11] IRC Sec. 421(d)(1)(B).
[12] IRC Sec. 421(d)(1)(A)(i).
[13] IRC Sec. 421(d)(1)(C).
[14] IRC Sec. 421(a).
[15] See footnote 14.
[16] IRC Sec. 421(a) and Reg. 1.421-5(a)(4) example (1) and (2).
[17] See footnote 14.
[18] IRC Sec. 421(b).
[19] See footnote 18.

not fulfilled, ordinary income will be recognized by John in the year that the option fails to qualify.[20] Thus, the benefits of a stock option plan may be lost from the very beginning or as the result of an event happening in a year subsequent to initiation. The failure to hold stock for six months from the date of exercise is an example of such a disqualifying future event. The value of the stock on the date the option fails to qualify for special treatment determines the amount of income John would recognize. If the disqualification occurs in a year subsequent to the year granted, the additional income will be picked up at that time rather than through the filing of an amended return.[21]

If a restricted stock option plan is inaugurated, certain warnings must be given to John. First of all, the holding periods required to gain the benefits under a restricted stock option must be adhered to explicitly. Secondly, if the corporation is listed on a national exchange, John as an officer may be subject to the rule contained in Section 16(b) of the 1934 Securities Exchange Act. This requires that an insider pay to the corporation profits realized from the purchase and sale of stock within a six-month period. If John falls within this category and does enter into one of the prohibited transactions, not only will the effectiveness of the stock option plan be nullified, but also John may end up with capital losses which can only be offset against future capital gains. Due to the fact that different bases may be assigned to the same stock for purposes of determining the amount to be repaid to the corporation and that used to determine gain from the transaction, it is possible for an executive to recognize no gain for tax purposes but yet be required to pay money to the corporation. Revenue Rule 61-115 allows the executive to deduct amounts repaid to the corporation from gains recognized for tax purposes. However, in a situation in which the gain is different from the amount repaid, some of the amount repaid may have to be carried over to future years and utilized as a short term capital loss.

The real significance of a restricted stock option does not arise until the market value of the stock appreciates substantially over the market value of the stock at the time the option was granted. If, instead of appreciating, the value of the stock depreciates, such as many corporation stocks did in the Spring of 1962, options lose their value. Here again the Internal Revenue Code has made some provision for modifications of the option price.[22]

[20] IRC Sec. 421(f).

[21] See footnote 20.

[22] IRC Sec. 421(e).

As a general rule, the adequacy of the price to determine whether the option is a restricted stock option will depend upon the value of the stock, both at the date of granting and the date of any modification. The only exception to this arises when the average price for the 12 months immediately preceding the date of modification is less than 80 per cent of the market value at the time the option was originally granted. If this condition exists, the value at the date of modification governs the adequacy of the price of the option.

It should be realized that an important aspect of using stock options is the requirement that the basis of the stock must be related to its fair market value. The problem of determining the fair market value of its stock is one of the reasons why closely held companies find it difficult to use stock options in setting up compensatory plans for their executives.

In summary, the result of your investigation shows that both stock options, as well as nonqualified deferred compensation plans, have advantages as well as disadvantages.

Stock options, particularly restricted stock options, may be very advantageous both to John and to the corporation. They enable John to defer income and at the same time, under certain circumstances, realize substantial capital gains. The corporation at the same time benefits to the extent that John has an ownership interest in the corporation and is actively interested in improving the performance of the corporation. One of the principal drawbacks intrinsic to all stock options is that any advantage that may be gained requires John to commit relatively large sums of money to acquire and hold the stock in order to realize the full benefits from the restricted stock option plan. Aside from this is the relatively minor problem of complying with the technical requirements of a restricted stock option plan to gain the full benefits allowable.

Properly drafted, a nonqualified deferred compensation plan can defer a portion of John's current compensation and still preserve a deduction for the corporation at some time. To preserve the advantage to John, the plan must be drafted to avoid the application of the doctrine of constructive receipt and economic benefit. To preserve the deduction to the corporation, any segregation of assets must not be construed as a funding of the plan unless John has a nonforfeitable right therein. The plan which produces the most favorable results to both parties then appears to be an unfunded plan based on an unsecured contract in which John has either a forfeitable or nonforfeitable right.