Labor and Employment Bulletin

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> *FASB votes to encourage, but not require, expensing of stock options.*

In December, 1994, the Financial Accounting Standards Board ("FASB") announced its long awaited decision concerning the requirement of corporations to record an expense for employee stock options. The FASB decided not to require expensing of stock options based upon their estimated fair market values using option pricing models. Instead, it voted to encourage the expensing of stock options and require footnote disclosure of the cost of such options. It also decided to continue with its existing method of valuing options, thus continuing to treat fixed options differently than performance-based options. Although the FASB has made these decisions, it has not yet issued any revised drafts of its rules. It is expected that additional action will be announced in the spring.

IRS Proposes New Withholding Rules for Exercise of Stock Options

> *Certain employer liabilities remain if employees fail to report income recognized upon the exercise of stock options or the vesting of restricted stock.*

When an employee receives a taxable transfer of property for services (for example, upon the exercise of a nonqualified stock option or the vesting of restricted stock), the employer is allowed a deduction for the amount included in the income of the employee or service provider. However, current IRS regulations provide that a failure to withhold on this income causes a deduction to be denied. These rules have caused great difficulty for employers because the recognition of income upon the exercise of a stock option or the vesting of restricted stock does not allow a source of funds for easy withholding. The IRS has proposed an amendment to the regulations under Section 83 of the Internal Revenue Code that will eliminate the withholding requirement.

Under the proposed regulation the employer will be allowed a deduction for the amount includable in the income of the employee or service provider if the employer demonstrates that the recipient included the income on his or her tax return. If the employer timely submits Form W-2 or Form 1099 to the recipient and the IRS, the recipient will be deemed to have included the amounts in income. If the employer's reporting is not timely, the employer will have to prove that the recipient in fact included the income. This may be done by submitting a copy of the recipient's income tax return to the IRS. A special rule applies to income resulting from a disqualifying disposition of stock obtained from the exercise of an incentive stock option. In such a situation, the employer can claim a deduction if it files Form W-2 or W-2C before filing its tax return.

Relief from withholding does not give relief from penalties for failure to withhold. Thus, if the employee fails to include the taxable income on his return, the employer may be liable for the tax on the income and a penalty for failure to withhold.

The change is proposed to be effective for taxable years beginning on or after January 1, 1995, but may be used in years beginning before that date if the years are not closed.

Albertson's Reversed!

> *Ninth Circuit Reverses Itself and Disallows Current Deduction of Interest Payments Under Non-Qualified Deferred Compensation Arrangements*

The Ninth Circuit recently reconsidered and reversed the Albertson's decision, one of its earlier, and more highly publicized, decisions in which it allowed an employer sponsoring a nonqualified deferred compensation arrangement ("DCA") to deduct interest payments under the DCA as they accrued. **The Ninth Circuit now holds that an employer must wait until an employee actually receives the amounts which have been deferred on his or her behalf under a DCA before the employer may take a deduction with respect to such amounts.** The holding applies to both the compensation component and the interest component of the amount deferred under the DCA.

This conclusion, while less favorable to employers, is consistent with Congress's intent that the incentives under the Tax Code should encourage employers to adopt qualified plans as opposed to nonqualified plans. The Ninth Circuit was concerned that taking a too literal interpretation of §404(a) of the Code (concerning the timing of deductions under deferred compensation plans) would have the effect of creating an incentive for employers to adopt nonqualified plans. Therefore, employers sponsoring DCAs should be aware that this earlier interpretation of §404(a) has been withdrawn. Although another rehearing has been requested, most practitioners predict this request will be denied.

Changes in Rule 16(b) Under Consideration/Transferrable Options Possible

If you currently hold a stock option and exercise that right, there will be some income tax to pay either upon the exercise or the subsequent sale of the stock received (assuming the stock has increased in value over the option price). If you wish to transfer the value of that stock to a younger generation, then the full fair market value of the stock is subject to gift taxes. To minimize this tax consequence, some optionholders are considering the transferability of options (which of course cannot be incentive stock options). This would allow gifts to be made at a time when the asset which is the object of the gift has a very low value (merely the expectation of an increase in value) as opposed to the appreciated value of the stock acquired. For some individuals this can be an effective technique.

To facilitate the creation of transferable options, the SEC has indicated it may be willing to modify its Rules under Section 16 of the Securities Exchange Act of 1934. Under the current Rules, transferable options are not eligible for the Rule 16(b)(3) exemption from the restrictions on short-term trading by "insiders." While transferable options could nevertheless still be used to transfer wealth, the exemption would make it easier to comply with the requirements under Section 16.

The use of transferable options is of most interest to people who 1) expect to receive substantial numbers of options; 2) have children or grandchildren who could benefit from such a transfer; and 3) have the liquid assets necessary to pay the income taxes associated with the exercise of such options by the younger generation (since the income tax will still be due from the transferor). It should be noted that waiting for action by the SEC may not be necessary in all circumstances. Some interested executives already are exploring this technique.

FICA And FUTA Tax Treatment For Deferred Compensation Plans

Until regulations are issued, an employer's good-faith efforts to comply with the FICA requirements for a deferred compensation plan may suffice.

In prior years, amounts deferred under an employer's nonqualified deferred compensation plan for the benefit of an executive often were not subject to FICA tax because, by the time of the deferral, the executive's wages exceeded the dollar limit on wages subject to the tax. Two years ago, however, Congress repealed the dollar limit on wages subject to the Medicare portion of the FICA tax. This action had the effect of increasing the number of taxpayers subject to FICA tax on amounts deferred under deferred compensation plans.

The IRS recently announced that it will issue regulations explaining how employers with deferred compensation plans are to comply with FICA requirements. Until the regulations are issued, the IRS has stated that it will not challenge any employer's good-faith effort to determine FICA liability for deferred compensation plans. The IRS cautioned, however, that an employer may not try to avoid the FICA tax for a year by treating amounts deferred under a plan as compensation for services performed prior to the adoption of the deferred compensation plan. The IRS also advised employers that they must withhold applicable FICA and FUTA taxes on deferred compensation on the date that the employer treats the amounts as paid, which must be at least annually. The FICA and FUTA taxes must also be deposited under the regular rules applicable to tax deposits.

New IRS Guidance Issued On The One Million Dollar Deduction Limit On Compensation Of Executives

Equity-based compensation takes on increased importance in light of limits on deductibility of executive compensation.

Beginning in 1994, no deduction is generally allowed to a publicly-held corporation for compensation paid during the year in excess of $1 million to "covered employees," which includes the chief executive officer and the four highest paid officers whose compensation must be disclosed in proxy material.

Performance-based compensation is an exception to this limitation. Compensation is performance-based if:

- It is payable solely on attainment of pre-established, objective "performance goals" set by the compensation committee of the Board of Directors, which must be comprised solely of two or more outside directors;
- The performance goal is established in writing by the compensation committee prior to the commencement of the services to which the goal relates and while the outcome is substantially uncertain.
- Material terms of the compensation (including performance goals) are approved by the shareholders before payment; and
- The compensation committee certifies that the goals are satisfied.

The IRS recently issued new proposed regulations to clarify the deduction limit. Highlights of the regulations include:

Compensation Committee.

The compensation committee need not be responsible for establishing and administering an entire compensation program. It need only establish and administer performance goals.

Pre-established Performance Goal.

A performance goal is "pre-established" if it is set forth in writing not later than 90 days after the beginning of the period of service involved, provided that the attainment of the performance goal is "substantially uncertain."

"Substantially Uncertain" Requirement.

Attainment of a performance goal based on corporate profitability is substantially uncertain even for companies with a history of profitability.

Awards as a Percentage of Salary.

Awards based on a percentage of base pay will be viewed as based on an objective standard, provided that the maximum dollar amount payable is fixed at the time the goal is established.

Shareholder Approval.

Shareholder approval of performance goals must be obtained before the compensation is paid, but not necessarily before the beginning of the period of service to which the goal relates.

Outside Directors.

Directors who are "disinterested" under the securities laws are treated as outside directors until the first shareholder meeting after January 1, 1996 at which directors are elected.

The limit on deductibility requires public companies to review their executive compensation programs so that as much compensation as possible is performance based. More equity-based compensation, including stock options, should be considered as a means of avoiding the deduction limitation.

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