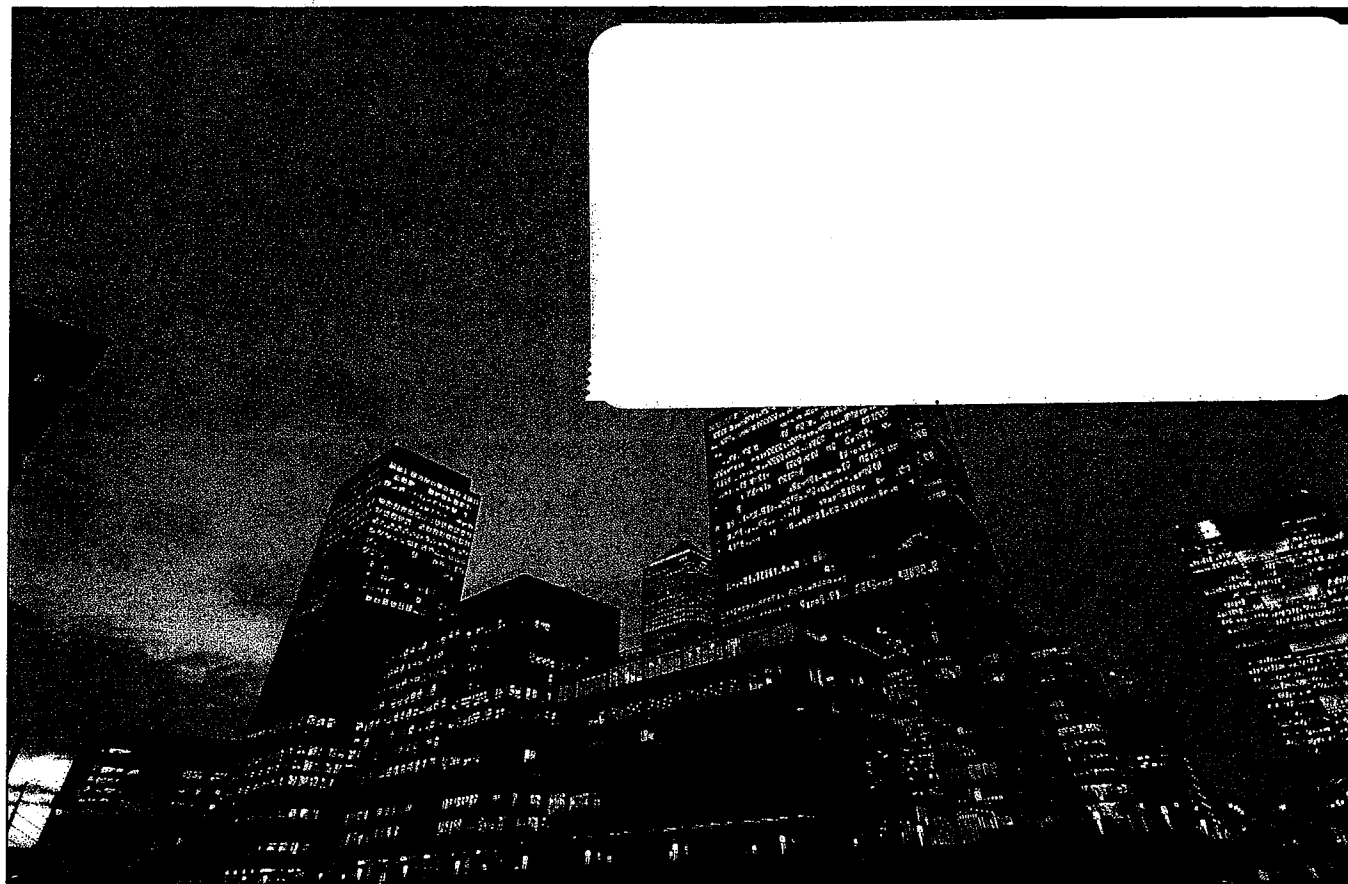


The Role of Deferred Tax Assets in Corporate Tax Reform



Oh, Never Mind: IRS Rescissions Ruling Practice

Practitioners Say *Bilski* Fails as Tax Patent Guidance

Partnerships With Reportable Entity Partners

10 Compensation Mistakes

How Would You Invest \$1 Billion Under the Current Tax System?

“ The decision doesn't really add much – I'm not sure why they decided it. ”

– Barry L. Grossman of Foley & Lardner LLP, discussing the Supreme Court's decision on tax patents in *Bilski*. (See p. 923.)

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10 Compensation Mistakes

By Bruce Shnider

Bruce Shnider is a professor of law at the University of Minnesota Law School and of counsel with Dorsey & Whitney LLP in Minneapolis.

Prof. Shnider presents a top-10 list of the key mistakes made in the executive compensation world and provides suggestions on how to avoid them.

A. Introduction

With apologies to David Letterman, having watched my share of episodes from his *Late Night* show, I am led to think about key mistakes that I have seen in the executive compensation world over the last several years.¹ While I am sure most people who work in that field could generate their own list of mistakes, I tried to create one for those actively engaged in the field, either designing plans and programs, or advising those that do. Therefore, this article provides the top 10 mistakes that I think practitioners should avoid.

10. Ignoring section 409A. A common mistake is ignoring section 409A as it applies to things other than officially designated deferred compensation plans. We all know that it applies to those, but it also applies in a lot of other situations.² The most important is termination and severance agreements, which must be reviewed.

Many companies fail to recognize that section 409A can also apply to termination and severance provisions when there are any payments following termination of employment, as well as some stock option purchase plans.³ Section 409A will apply to nonstatutory stock options (that is, not incentive stock options) if "the amount required to purchase stock under the option is less than the fair market value of the underlying stock on the date the option is granted."⁴ Companies should have those agreements properly reviewed to ensure compliance with section 409A.

¹For over 25 years I have had an extensive practice advising clients in the Twin Cities of Minnesota concerning executive compensation matters.

²I would like to thank Ross Rankin, recent graduate from the University of Minnesota Law School, for his assistance in preparing this article.

³Mark P. Altieri, "What the Closely-Held Employer Needs to Know About the New Code Section 409A Nonqualified Deferred Compensation Rules," 12 *J. Deferred Compensation* 60, 65-66 (2007).

⁴*Id.*

The failure to consider section 409A can lead to unexpected tax penalties. The cost of failure here is quite large, a potential penalty tax of 20 percent plus a higher than normal interest rate charged by the IRS on the resulting underpayment of taxes. Accordingly, everyone has a strong interest in addressing those issues.

9. Ignoring FAS 123(R). Financial Accounting Standard No. 123(R) is the most important development affecting executive compensation in the last several years. No company should be ignoring it. Here are a few of the key requirements that should get the most attention.

a. Compensation expenses. The most vital consequence of FAS 123(R) is that companies must now expense the cost of all equity compensation paid to employees. That is a marked departure from the former rule, which did not require companies to expense all of those costs.

b. Forced review of options. One of the past chief advantages of using stock options as a portion of executive compensation was that there was no expense that appeared on a company's financial statements. Now, FAS 123(R) will force companies to evaluate whether stock options are the most desirable form of equity compensation.⁵ Simply because options were used in the past is not a good enough reason to continue using them in light of the effects and requirements of FAS 123(R).

c. Complexity of the new rules. FAS 123(R) also imposes on companies myriad complex accounting rules. To meet the requirements of FAS 123(R), companies must be diligent in keeping careful and current records.⁶ Almost everyone has a compensation budget influenced by generally accepted accounting principles. But not everyone is actually managing that budget wisely.

8. Doing everything in-house. Most companies are focused on cost saving, which often means doing everything related to executive compensation in-house, as opposed to hiring outsiders to provide essential functions. Companies taking that route would be prudent to follow two key pieces of advice.

First, beware the allure of the Internet. There are numerous websites that allow a user to view, for free or a modest fee, the compensation plans of other companies.⁷ Other websites attempt to help a user create a

⁵See Investopedia.com, "A New Approach to Equity Compensation," available at <http://www.investopedia.com/articles/06/FAS123R.asp> (last visited Apr. 18, 2010).

⁶See Nancy Nichols and Luis Betancourt, "Options and the Deferred Tax Bite," *J. Accountancy*, Mar. 2006.

⁷See, e.g., Sample Business Contracts, available at <http://contracts.onecle.com/type/24.shtml> (showing the compensation plans of such companies as Prudential Financial, Ford Motor Co., and Hewlett-Packard).

compensation plan by providing a host of general information, but they give very little in the way of specific advice that would be useful to an individual company.⁸ However, just because you can find the omnibus equity plans for all of your competitors does not mean that just cutting and pasting provisions from those plans makes any sense for your company. Someone still has to think about how those different provisions work together and what makes sense for your company.

Second, learn to use the special skills of those outside the company. In most cases, the use of outside counsel with expertise and experience in compensation together with outside compensation consultants is probably still necessary. Don't just dump the project on outsiders, but do employ their special skills to help you.

7. Adopting section 280G parachutes and gross-ups without analyzing the cost. Section 280G is the golden parachute provision of the code which often comes into play in any change of control situation. There are some key things a company should be aware of regarding those provisions that may allow it to avoid dire consequences.

First, the costs imposed by those provisions can be enormous, and they have material financial consequences. If a parachute payment made to an executive constitutes an excess parachute payment, the corporation loses the ability to deduct the entire payment. Instead, the corporation can only deduct the "base amount," which is the executive's average compensation over the five years before the parachute payment.⁹

The financial consequences of the inability to deduct the entire payment becomes apparent when the size of recent parachute payments is considered. When Procter & Gamble acquired Gillette in 2005, then-CEO James Kilts received a parachute package worth \$188 million. Bruce Hammonds, former CEO of MNBA, received more than \$100 million when Bank of America acquired MNBA. And former Morgan Stanley CEO Philip Purcell gained \$113.7 million from his golden parachute.¹⁰

Second, gross-ups are costly. An executive who receives an excess parachute payment must pay a 20 percent excise tax on the payment.¹¹ The sting of the excise tax is often removed through the use of a gross-up, which is a payment made by the corporation that covers the executive's tax liability in connection with the parachute payment. Because the code considers a gross-up to be a parachute payment as well, additional tax must be

paid on the amount of the gross-up. That may effectively more than double the cost of the gross-up.

If a corporation chooses to make (or makes inadvertently) an excess parachute payment and uses a gross-up to offset the executive's tax burden, the costs can be significant. Any company should want to know how big that liability can be, and should take steps to address it. There are ways that a corporation can plan its parachute payments so as to make them less costly. One method is the parachute payment cap, which typically provides that the amount of the payment will be limited to 2.99 times the base amount of the executive's compensation.¹²

In an extreme case, all of this could affect a company's ability to do friendly, wanted deals. The exercise is important and should be repeated every couple of years as facts change.

6. Ignoring administrative expenses and complexity. Everyone seems to be cutting back on their compensation departments, but that creates a risk, as failure there leads to lost opportunities. Compensation plans, whether those that cover only executives or those that cover an entire company, must be monitored so that the company and its employees can get the most out of them. A failure to monitor can lead to consequences that could have been avoided with prior planning.

Allowing an in-the-money option to lapse is inexcusable. But, it happens — greater than "10 percent of all valuable [stock] options expire unexercised every year."¹³ Although an executive who is granted nonqualified stock options may wish to delay exercising them because they are subject to tax on exercise, in-the-money stock options should never expire unexercised.

Companies should know that preventative measures are worth the cost of implementation, and that they need to spend time and money on avoiding problems with their compensation plans. These programs can be done in-house.

5. Ignoring accumulated wealth in the hands of executives. At least in the recent past, companies rarely looked at this issue. One public company CEO had accumulated billions in value in his stock option portfolio. In another case, Larry Ellison, the founder and CEO of Oracle, has long been recognized as one of the highest paid executives in the United States. In 2009 he was listed No. 1 on Forbes Executive Pay in 2009.¹⁴ In 2007 he received \$61.1 million in compensation. But most of it came in the form of stock option awards. Ellison was paid a \$1 million base salary and received \$8.3 million in a cash bonus, but was given \$50 million in option awards.¹⁵ According to *Forbes*,

⁸See, e.g., How to Write a Compensation Plan, available at <http://blogs.payscale.com/compensation/2009/02/how-to-write-a-compensation-plan.html> (laying out basic conceptual ideas about compensation plans). This website provides a wealth of links to related topics. While most of the links do provide broad advice that may be relevant for several companies, the individual company looking to tailor a compensation plan to its needs will likely not find it there.

⁹Section 280G(a).

¹⁰Gordon Platt, "Going for Gold: Mergers Inflate Golden Parachutes as Payouts to CEOs of Target Companies Soar," *Global Finance*, Mar. 2006, 18-19.

¹¹Section 4999.

¹²See Bruce J. McNeil, "Parachute Payments: Preparation for a Soft Landing," *Journal of Deferred Compensation* 41.

¹³Lewis Braham, "Options: Have an Exit Plan," *BusinessWeek.com*, June 18, 2007, available at http://www.businessweek.com/magazine/content/07_25/b4039098.htm.

¹⁴*Forbes.com*, Larry Ellison Profile, available at <http://people.forbes.com/profile/larry-ellison/60466> (last visited Apr. 20, 2010).

¹⁵*N.Y. Times.com*, "Executive Pay: The Bottom Line for Those at the Top," available at http://www.nytimes.com/interactive/2008/04/05/business/20080405_EXECCOMP_

(Footnote continued on next page.)

by 2009 Ellison had accumulated \$474.9 million of unexercised options that were then exercisable.¹⁶

The question with accumulated wealth is what effect will it have on the executive's decision-making? Will he be more risk averse or less? Some executives might take fewer chances and become more conservative in their handling of the company to preserve the value of their options. But for an executive whose unexercised options have an extremely high value, he may have an incentive to engage in *riskier* behavior in an attempt to increase that already large value. For example, suppose Ellison is presented a risky transaction that has a high probability of failing and lowering Oracle's stock by some non-catastrophic amount. But the transaction also has a significant probability of being successful and increasing the value of Oracle's stock by a significant amount. Aside from any considerations of the business judgment rule, Ellison may choose to go ahead with the transaction because of its upside. If the transaction fails, the value of Ellison's options will be worth less, but they still will represent a lot of money. In short, having accumulated wealth in the hands of executives may make them more tolerant of risky transactions.

The effect of accumulated wealth on risk tolerance is unknown. Shareholders and compensation committee members should spend time considering the effect that accumulated wealth will have on the risk tolerance of the executives.

4. Treating everyone the same. It has long been standard operating procedure at many companies to treat all employees the same, for a host of reasons. Foremost among those reasons is that many companies find it hard to make distinctions among rank-and-file employees or senior executives.

However, current trends and regulatory reforms are forcing companies to distinguish some employees from others. Companies are now required to expense stock option awards, meaning that making option awards available to all is simply not financially feasible. Not everyone can be treated the same; not everyone can get big option or restricted stock grants.

Government mandated accounting standards and disclosure requirements are not the only reason to differentiate among employees. There are the important questions of incentives and retention: A company must provide a reward structure to motivate its employees to perform and to stay with the company. Each company must ask and answer why it cares about retaining a given person and how it plans to do so. Inevitably, employees are clearly going to be treated differently. Companies will have to learn how to manage the process of creating and calibrating an incentive structure.

3. Allowing management to control all compensation information and expertise. The key question to ask here is do all compensation consultants really work for management? The answer is that in many companies the

executive compensation department effectively works for management, as does any outside compensation consultant.

As a result, the compensation committee of the board of directors is really not independent and quite often merely reacts to the requested types of awards and the list of those to be awarded anything. In recent years, that lack of independence of many compensation committees has become a cause for concern. In 2002 *The New York Times* reported a study that examined approximately 2,000 of America's largest corporations. *The Times* found that more than 20 percent of those corporations' compensation committees "had business ties or other relationships with the chief executive or the company that could compromise their independence."¹⁷ Even a compensation committee's use of an outside consultant to aid it in setting executives' pay does not appear in practice to resolve perceived conflicts of interest: The consultants hired by the compensation committee are usually recommended by the CEO.¹⁸

However, the recently enacted say on pay legislation may force companies to change those practices, as some are now attempting to address shareholder concerns over executive compensation by retaining outside consultant firms to issue "fairness" opinions on the board's compensation decisions.¹⁹ The consultant hired by DuPont, however, did not "cover the merits, amounts or types of pay awarded."²⁰ It looked instead at the board's process in setting executive compensation in order to determine whether the process was "appropriate and effective."²¹ Critics of consultants' "fairness" opinions allege that companies are merely buying a rubber stamp.²²

In today's market, the compensation committee is supposed to play a bigger role. To do that it needs information. At the very least, the compensation committee should have its own consultant with authority to collect all relevant information from management.

2. Using restricted stock or performance-based awards just because everyone else is. Some claimed options died because they now represent a cost. In the 1990s, companies persuaded Congress to prevent the Financial Accounting Standards Board from including options in expenses.²³ But with the implementation of FAS 123(R), which took effect for annual reporting periods beginning after June 15, 2005, companies are now required to expense stock options granted to employees.

As a result, many companies started to switch to restricted stock. In July 2003, Microsoft abandoned its practice of using stock options and instead began issuing

¹⁷Diana B. Henriques and Geraldine Fabrikant, "Deciding on Executive Pay: Lack of Independence Seen," *The New York Times*, Dec. 18, 2002.

¹⁸*Id.*

¹⁹Joann S. Lublin, "Firms Use Outside Adviser to Judge Executive Pay," *The Wall Street Journal*, Mar. 22, 2010.

²⁰*Id.*

²¹*Id.*

²²*Id.*

²³David Henry, "How the Options Mess Got So Ugly — and Expensive: As Grants Soared in the 1990s, So Did the Temptation to Cheat When Issuing Them," *BusinessWeek*, Sept. 11, 2006.

GRAPHIC.html?# (last visited Apr. 20, 2010) (click on Lawrence J. Ellison's profile from the list on the left of the page).

¹⁶See *supra* note 14.

restricted stock units (RSUs) to employees as equity compensation.²⁴ Microsoft made that change partially in anticipation of FASB's new rule requiring companies to count stock options as an expense.²⁵

Initially companies structured their restricted stock so that they vested after a specified amount of time — just stay on the job and you get it. For example, the company may require an employee who receives restricted stock to remain employed with the company for three years before the stock vests. However, over time, companies decided to use performance-based vesting rather than time-based vesting. But how easy is it to measure and communicate performance benchmarks? Many companies' incentive plans, which include restricted stock plans, use a large number of criteria to measure company performance.²⁶ Because Microsoft did it, some companies also decided to use RSUs rather than real restricted stock.

Are restricted stock and RSUs appropriate for everyone? Although not as popular as they once were, options may still be the best choice for some businesses, including high-growth companies and companies that plan to go public or be acquired.²⁷ In some industries, such as

high-tech start-ups, employees expect to receive options.²⁸ Compared with restricted stock, options have more upside. All else being equal, the holder of an option can make much more money than a holder of restricted stock, as long as the value of the stock underlying the option increases. Therefore, it may be appropriate for particular businesses to create this potential for high gain through an option program: "A big carrot is necessary to persuade the best people to leave good positions at big companies and come to work at risky new businesses."²⁹

1. Creating incentives to engage in the wrong behavior. Everyone knows the story of the company that paid bonuses based on sales but lost money because no one worried about price. It still happens. See, for example, Wall Street mortgage backed securities sales. You have to look carefully at your formulas and spend time with focus groups to see how it is interpreted by both the rank and file and senior executives. What will people do to game the system, and can you control and manage that?³⁰

B. Conclusion

Addressing all 10 of these issues won't save the world, and it might not even satisfy congressional concerns about unreasonably high levels of executive compensation. However, avoiding common personnel and tax mistakes may lead to programs that both work better and are more understandable to executives, shareholders, and the public.

²⁴"Microsoft's Bold New Pay Plan," BusinessWeek.com (July 21, 2003).

²⁵*Id.*

²⁶For example, Coca-Cola's Performance Incentive Plan provides that the "Compensation Committee may designate one or more performance criteria" from a list of performance measures approved by shareholders. The approved list contains 23 measures, including net revenue, net income, gross profit, return on capital, earnings before interest, taxes, depreciation, and amortization, earnings per share, and value share of the nonalcoholic ready-to-drink segment. Each year, a target incentive is created for each employee who participates in the plan. Proxy Statement of the Coca-Cola Company, 79 (2009).

²⁷"How to Choose an Employee Stock Plan for Your Company," The National Center for Employee Ownership, available at <http://www.nceo.org>. See also *supra* note 24. ("It may still be

appropriate for many startups to use stock options when they are an essential spur for innovation, especially in Silicon Valley.")

²⁸*Id.*

²⁹See *supra* note 24.

³⁰Although the number 1 mistake many companies make is simply paying too much, I decided that item was both too political and too well known to be a useful addition to this article.

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(Footnote continued in next column.)