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Bonus and Incentive Compensation Awards—Navigating Section 409A, $1 Million Limit, and Golden Parachutes Rules

As the area of executive compensation has become increasingly regulated, navigating applicable tax law requirements when granting compensation awards has become a growing challenge. This article provides an overview of some key aspects of Section 409A, the $1 million limit under Section 162(m), and the golden parachute rules under Section 280G that employers should keep in mind when making bonus and incentive compensation awards.

SECTION 409A

Annual bonus and other incentive compensation awards (collectively, "awards") can be designed to be either exempt from, or compliant with, Section 409A. In order to retain maximum flexibility with respect to modifying awards (such as accelerating payment, changing payment terms, or even canceling awards and replacing them with something else), it is generally preferable, where possible, to design awards to be exempt from Section 409A. Section 409A exemption/compliance alternatives for different types of awards are discussed below.

ANNUAL CASH BONUSES

Several Section 409A strategies are available for annual cash bonuses:

- *Exempt Because No Legally Binding Right:* If the amount and payment of an annual bonus award is fully subject to an employer's discretion, the award should generally be exempt from Section 409A, because the recipient employee has no legally binding right to payment of the award until it is actually paid. Under Section 409A, unless an award grants a legally binding right to compensation in a later year, there is no deferral of compensation for purposes of Section 409A.
- *Exempt As Short Term Deferral:* Cash bonus awards are often designed to comply with the short term deferral exception to Section 409A. In general, the short term deferral exception will apply if a compensation award is required to be, and actually is paid, within two and a half months after the end of the year during which the executive obtains a vested right to the payment.
- *Comply with Section 409A Deferred Compensation Requirements:* If a bonus award is not exempt from 409A, it must, at the time of grant, (a) specify a permissible time of payment (a specified date or even year of payment is sufficient); (b) specify the form of payment (e.g., lump sum, installments, etc.); and (c) in the case of a publicly traded company, if the payment may in some circumstances be triggered by termination of employment (such as under the terms of an employment agreement), provide for a delay in payment of six months if the payment is to a "specified employee" (as defined under Section 409A) and is triggered by separation from service.

STOCK OPTIONS

Stock options are almost always designed to be exempt from Section 409A. In order to be exempt from Section 409A, a stock option must satisfy the following requirements:

- *Option Must Cover Service Recipient Stock:* The stock covered by the option must be common stock (options on preferred stock are not allowed) of the employer (the legal entity actually employing the employee) or, generally, a direct or indirect parent thereof. Options may not be granted on the stock of a subsidiary of the corporation employing an employee.
- *Exercise Price Must Be Not Less Than Fair Market Value:* The exercise price must be not less than fair market value on the date of grant of the option. In the case of an option on stock traded on an established securities market, the regulations under Section 409A permit a number of pricing methodologies, all of which are based on actual market prices. In the case of an option on nonpublicly traded stock, fair market value must be determined by "the reasonable application of a reasonable valuation method." This is

a higher standard than the "good faith" standard applicable to pricing incentive stock options (ISOs) at fair market value. The regulations under Section 409A provide a number of safe harbors that may be used to establish the fair market value of nonpublicly traded stock.

- *No Deferral Features:* The option cannot have any deferral features (beyond those inherent in an option), such as the ability to defer receipt of shares upon exercise of the option.

Restricted Stock

Restricted stock is exempt from Section 409A, because it constitutes the transfer of property subject to Section 83. This makes restricted stock particularly attractive from a Section 409A perspective.

Restricted Stock Units

Restricted stock units (RSUs), which involve the payment of stock or cash on a future date or event, are generally subject to Section 409A unless designed to comply with the short term deferral exception (as described above with respect to bonus awards). Although RSUs are, in many ways, economically equivalent to restricted stock, they are accorded fundamentally different treatment under Section 409A. Because restricted stock is exempt from Section 409A, an employer that utilizes restricted stock generally has more flexibility to make changes to its awards than an employer that utilizes RSUs.

$1 Million Limit Under Section 162(m)

In many cases, publicly held companies design compensation awards made to "covered employees" (and employees who may become covered employees prior to payment of an award) to comply with the performance based compensation exception to the $1 million limit under Section 162(m). Key requirements of that exception are as follows:

Grant and Certification by a Qualifying Compensation Committee

The award must be granted by a compensation committee comprised of at least two or more "outside directors." Except in the case of stock options and stock appreciation rights (SARs) that meet the requirements described below, the committee also must certify that the performance goals and any other material terms of the arrangement were satisfied before payment is made. A director is an "outside director" only if he or she is not:

- A current employee of the publicly held corporation;
- A former employee of the corporation who is receiving compensation for prior services (other than benefits under a tax qualified pension plan);
- A former officer of the corporation; or
- Receiving remuneration from the corporation, either directly or indirectly, in any capacity other than as a director.

Performance Goal Requirement

Payment of the award must be contingent on the attainment of one or more pre-established objective performance goals. A performance goal is treated as "pre-established" if it is established by the compensation committee not later than 90 days after commencement of the period of service to which the performance goal relates, provided that the outcome is substantially uncertain and not more than 25 percent of the performance period has expired. A performance goal is objective only if a third party with knowledge of the relevant facts would be able to determine the extent to which the goal was satisfied and the amount of compensation that would be payable to the employee. A compensation committee may retain discretion to reduce the amount payable upon achievement of the performance goal(s).

Stockholder Approval Requirement

The award must generally be made under a stockholder approved plan that authorizes the performance goals(s) used in the award and contains a cap on the amount that can be paid to an executive during a specific period.

Special Rules for Stock Options and SARs

Special rules apply to stock options and SARs. Under these rules, a stock option or SAR is deemed to constitute qualifying performance based compensation if: (a) the grant is made by a qualifying compensation committee; (b) the plan under which the option or SAR is granted states the maximum number of shares with respect to which options or SARs may be granted during a specified period to any employee; and (c) the exercise price of the option or base price of the SAR is not less than the fair market value of the stock on the date of grant. If these requirements are not satisfied, a stock option or SAR may nonetheless satisfy the performance based exception if the grant of the option or SAR or its vesting is subject to achievement of one or more qualifying performance goals.

Golden Parachute Rules

Vesting Schedules

The accelerated vesting of compensation awards upon the occurrence of a change in control or termination of employment in connection with a change in control can increase the amount of an executive's parachute payments. In general, a longer vesting schedule results in increased parachute payments upon accelerated vesting, and accelerated vesting upon the occurrence of a change in control results in greater parachute payments than accelerated vesting only upon termination after a change in control (assuming termination does not occur immediately upon the change in control).

One Year Presumption

Awards made within one year prior to a change in control may be deemed to be parachute payments under the golden parachute rules.

Locking in Current Interest Rates for Accelerated Payments

Payment of compensation awards is often accelerated by a change in control. Under the golden parachute rules, the present value benefit of receiving payment of a compensation award on an accelerated basis is a parachute payment. For purposes of calculating present value, the interest rate (120 percent of the applicable federal rates compounded semiannually) in effect at the time of the change in control is generally used. An employer and employee may, however, agree in the contract providing for a parachute payment to use the interest rate in effect on the date of the contract. Because current interest rates are generally low by historical standards, locking in current interest rates for calculating parachute payments resulting from the accelerated payment of awards can potentially reduce the amount of parachute payments an employee receives (thereby reducing the amount of excise taxes or the effect of golden parachute caps).

Nontax Considerations

Among the nontax considerations to be taken into account when making compensation awards are the accounting treatment of the awards, how the awards will be disclosed under the U.S. Securities and Exchange Commission's (SEC's) proxy and other disclosure rules, and institutional shareholder reaction.

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