A PRIMER ON STOCK-BASED COMPENSATION AND SELECTED RECENT DEVELOPMENTS

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II. FINAL GOLDEN PARACHUTE REGULATIONS

On August 1, 2003, the IRS issued a final regulation (the “final regulation”) under I.R.C. § 280G covering the denial of a deduction to a corporation for any “excess parachute payment.” The provisions of the final regulation also apply for purposes of the 20% excise tax imposed by I.R.C. § 4999 on recipients of excess parachute payments. The IRS concurrently issued Revenue Procedure 2003-68, providing guidance on the methods that may be used to value stock options for purposes of these provisions.

The final regulation replaces the proposed regulations issued in 2002 (the “2002 proposed regulation”) and in 1989 (the “1989 proposed regulation”). The final regulation does not depart significantly from the 2002 proposed regulation and includes a number of helpful clarifications. Certain of the controversial features of the 2002 proposed regulation, such as the valuation methodology for stock options, remain in the final regulation. Included as Annex A hereto is a reprint of an article from the October 2003 issue of The M&A Lawyer discussing the final regulation.

A. PRINCIPAL CHANGES/CLARIFICATIONS FROM THE 2002 PROPOSED REGULATION

The final regulation modifies the 2002 proposed regulation in a number of ways the most significant of which are noted below. In determining whether a change in control has occurred, the final regulation:

- retains the rule from the 2002 proposed regulation that prohibits taking into account overlapping share ownership to conclude that neither corporation has undergone a change in control;
• generally adopts the "one change" rule that if one corporation undergoes a change in control, the other corporation involved in the transaction does not undergo a change in control;\textsuperscript{38} and

• provides that whether a sale of assets constitutes a change in control is determined by the gross fair market value of assets without regard to any liabilities associated with such assets.\textsuperscript{39}

In exempting payments from the definition of "parachute payment," the final regulation:

• clarifies that a domestic corporation eligible to elect treatment as an S corporation under the I.R.C. may use the exemption for small business corporations, even if it does not elect S corporation treatment; and

• simplifies the private corporation shareholder approval procedures by permitting shareholders of record to be determined on any day within a six-month period ending on the change in control. The preamble to the final regulation also clarifies that a foreign corporation eligible to be treated as a private corporation may use the shareholder approval exemption.

\textsuperscript{38} See the preamble to the final regulation.

\textsuperscript{39} This rule is also applied in determining the voting requirements applicable to an entity shareholder of the payor corporation for purposes of the shareholder approval procedures. (These requirements depend on whether a substantial portion of the assets of the entity shareholder consist of the payor corporation's stock.)
In calculating parachute payments, the final regulation:

- provides that the full amount of a payment (instead of the portion attributable to acceleration of vesting or payment) pursuant to an agreement entered into or modified within one year of a change in control generally is treated as contingent on the change in control and potentially subject to excise tax;\(^{40}\)

- provides that the portion of a payment treated as contingent on a change in control cannot exceed the amount of the accelerated payment or, if the payment is not accelerated, the present value of the payment; and

- clarifies that the base amount includes all amounts received by a disqualified individual for the performance of personal services for a corporation during the base period, potentially resulting in lower base amounts (and higher excise taxes) for individuals who serve the corporation variously as independent contractors and employees during the base period.\(^{41}\)

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\(^{40}\) For example, assume that options were granted on January 1, 2004 with one-year cliff vesting on January 1, 2005 as part of a corporation's annual option program and pursuant to a plan that provides for full vesting on a change in control. Under the final regulation, if a change in control occurs on December 1, 2004 (and the presumption that the grants were contingent on a change in control is not rebutted), the full value of the options, rather than the portion attributable to one month of accelerated vesting, is presumed to be contingent on a change in control and potentially subject to excise tax.

\(^{41}\) For example, if an individual earned $30,000 in director fees in 2004 and 2005 and then became an executive with annual compensation of (continued. . .)
Additionally, the final regulation provides that the holder of an unvested option or a vested option that is exercisable only for restricted stock generally is not considered to own the underlying stock, such as for purposes of the rules on identifying disqualified individuals and determining if a change in control has occurred. The holder of a vested option exercisable for unrestricted stock is generally treated as the owner of the underlying stock, other than for purposes of the shareholder approval exemption.

B. BACKGROUND

Under I.R.C. §§ 280G and 4999, no deduction is allowed to a corporation for any excess parachute payments made to a “disqualified individual” and the recipient of the payment is subject to a non-deductible 20% excise tax in addition to any regular income tax (which may be incurred at a different time). In general, a payment will be treated as a “parachute payment” if (i) the payment is compensatory in nature and contingent on a change in control (as defined by regulation) of the corporation and (ii) the present value of the aggregate of all such payments received by the disqualified individual equals at least three times the individual’s base amount.\(^42\) Payments for this purpose are not limited to cash

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$500,000 in 2006 and $600,000 in 2007, the base amount calculation with respect to a change in control occurring in 2008 would include all amounts earned as a director and as an executive \(((\$30,000 \times 2) + \$500,000 + \$600,000)/4 = \$290,000)\) instead of just amounts earned as an executive \((\$500,000 + \$600,000)/2 = \$550,000)\). Because excise tax is applied to parachute payments that exceed three times an individual’s base amount, a smaller base amount increases an individual’s exposure to excise tax liability.

\(^{42}\) A parachute payment also includes any payment of compensation to a disqualified individual that is made pursuant to an agreement that violates any generally enforced securities laws or regulations.

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payments but include the value of other benefits, e.g., the accelerated vesting of stock options. The "base amount" is the disqualified individual's average annual compensation from the corporation which undergoes a change in control that is includible in gross income during the five complete years ended immediately preceding the change in control. The amount of a parachute payment can be reduced if it is shown to be reasonable compensation for services performed, or to be performed, by the individual. The "excess" amount of any parachute payment is the amount by which it exceeds the allocable portion of the individual's base amount. The amount of a parachute payment can be reduced to the extent it is shown to be reasonable compensation for services performed, or to be performed, by the individual.

C. EFFECTIVE DATE

The final regulation applies to any payments that are contingent on a change in control occurring on or after January 1, 2004. The 2002 and the 1989 proposed regulations generally may be relied upon with respect to payments that relate to changes in control occurring prior to January 1, 2004. Revenue Procedure 2003-68 (relating to option valuation) applies with respect to changes in control

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Certain payments that are approved by shareholders of certain private corporations are excluded from the definition of a parachute payment.

If the disqualified individual has not been employed by the corporation for five complete years, the base amount is determined for the period of the individual's employment. Certain payments for partial years may be annualized for this purpose.

The preamble to the final regulation states, however, that "clarification in the 2002 proposed regulations does not support reliance on the 1989 proposed regulations for a position contrary to the provisions of the 1989 proposed regulations."
occurring on or after January 1, 2004 but may be applied by taxpayers with respect to transactions that occur prior to such date. 45

D. CERTAIN OBSERVATIONS

Although the final regulation does not fundamentally change the golden parachute rules, the following observations can be made:

- As discussed more fully below, the treatment of stock options upon a change in control should be carefully considered. In particular, accelerated vesting of an underwater option could result in excise tax liability even though the option might never be exercised because it remains underwater.

- Stock options and other awards with graded vesting are still favored over those with cliff vesting, and awards that vest on achievement of performance targets are subject to a separate regime.

- Certain limited events may provide an opportunity to redetermine an option’s value and possibly recoup a portion of excise tax previously paid by claiming a refund, as discussed more fully below. This redetermination feature could reduce the cost of providing excise tax gross-ups, depending on how the excise tax gross-up provision is drafted.

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45 Revenue Procedures 2002-13 and 2002-45 (the predecessors to Revenue Procedure 2003-68 which were issued in conjunction with the 2002 proposed regulation) may be applied with respect to changes in control occurring prior to January 1, 2004 but are revoked as of January 1, 2004.
E. REVISED TREATMENT OF STOCK OPTIONS

Under the final regulation, the accelerated vesting of a stock option in connection with a change in control is treated as a parachute payment, which must be valued under the relevant facts and circumstances. Contrary to some previous practices, but consistent with Revenue Procedure 2002-45, Revenue Procedure 2003-68 provides that this value cannot be based solely on the option spread at the time of vesting. The IRS has retained the controversial yet simplified safe harbor approach from Revenue Procedure 2002-13 for valuing options. The safe harbor allows the value of a stock option to be established based on the option spread (if any), the remaining term of the option, and a basic assumption regarding the volatility of the underlying stock, all as determined at the time of the change in control. This safe harbor valuation method may be used without regard to whether the underlying stock is publicly traded.

Although it is helpful to have a safe harbor for calculating option values, it is worth noting that the safe harbor methodology:

- can yield values for options that differ markedly from the income actually realized on option exercise or cashout, including producing a value for underwater options;

- may overstate the value of the option relative to the conventional methodology used for financial and proxy reporting; and

- may result in a determination that excise tax applies to underwater options that employees perceive to have no financial value.
Revenue Procedure 2003-68 does, however, give taxpayers additional flexibility in choosing an alternate valuation method:

- Taxpayers that do not use the safe harbor must use a valuation method consistent with generally accepted accounting principles that takes into account the same factors used in the Black-Scholes valuation methodology. The IRS has not prescribed the option term or volatility to be used in determining an option’s value outside of the safe harbor, other than requiring consistency with generally accepted accounting principles.

- The value of accelerated vesting of an option may be redetermined during the 18-month period following a change in control if (i) the term of the option is shortened due to a termination of the option holder’s employment or (ii) the volatility of the underlying stock decreases. All other factors in the redetermination remain the same, although a different valuation methodology may be used in the redetermination as long as it is otherwise permitted under the Revenue Procedure. The parachute payment and the excess parachute payment will be recalculated, and an individual may claim any resulting adjustment to his or her excise tax liability by filing an amended return for the taxable year in which the excise tax was previously paid.

In addition, Revenue Procedure 2003-68 clarifies that if options are exchanged in a change in control for options based on a different stock, the valuation is based on the substituted option (as opposed to the original option).