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Perspectives

AN EXECUTIVE COMPENSATION, BENEFITS & HUMAN RESOURCES LAW UPDATE

pillsbury

A LETTER TO OUR READERS…

Dear Reader,

New tax laws enacted in 2012 require the design and purpose of current and future deferred compensation to be reviewed. Further, as companies become more global, it has become necessary to understand how foreign laws may impact these arrangements. As always, the goal of this publication is to provide our clients and the industry with probing insights into recent legal developments affecting the executive compensation and benefits field. In this issue of *Perspectives*, we have striven here—as we do every day with our clients—to boil the legal principles down to their essence and apply them to real-world, commercial situations.

In this edition, my colleagues and I explore new developments regarding global stock plans compliance issues, and the legislative impact on the taxation of stock options and other forms of equity compensation, as well as how the 2012 tax law makes deferred compensation a more attractive benefit. While the articles present a general discussion of the issues, I do hope you will find these summaries of principal US and selected tax and global governance developments useful.

Thank you and we look forward to hearing your comments.

—Susan Serota
Leader, Executive Compensation & Benefits Practice

IN THIS EDITION…

IMPACT OF NEW 2013 FEDERAL TAX RATES ON STOCK OPTIONS AND OTHER EQUITY COMPENSATION

by James P. Klein and Susan P. Serota

The American Taxpayer Relief Act of 2012 and other recent legislation have affected the taxation of nonqualified stock options, restricted stock and restricted stock units, dividends and the sale of stock received under these awards. For a number of years, the top federal tax rates have been 35% for ordinary income, and 15% for dividends (qualifying) and capital gains. There are also changes in the alternative minimum tax ("AMT") applicable to incentive stock options. Employees and self-employed persons are also subject to Social Security and Medicare taxes, both of which have changed. Consequently, effective January 1, 2013, taxation of equity awards under the Internal Revenue Code has changed, and the changes are quite complicated.

What hasn't changed:

Income Tax

Taxpayers with income under $200,000 ($250,000 for joint returns)

For taxpayers at this level of income, the income tax rates have not increased in 2013.

What has changed:

Tax on Net Investment Income

A new 3.8% tax on "net investment income" (e.g., capital gains and dividends) applies to the extent modified adjusted gross income exceeds $200,000 ($250,000 for joint returns).

Income Tax

Taxpayers with income over $250,000 but less than $400,001 ($300,000 but less than $450,001 for joint returns)

For taxpayers with income in this range, there are no regular rate changes on income, capital gains or dividends, but the new 3.8% tax on net investment income may apply and there are new limitations on itemized deductions and personal exemptions.

Taxpayers with income of $400,000 and over ($450,000 for joint returns)

For taxpayers with income over this level, there is a new rate of 39.6% on ordinary income, and the tax rate on long-term capital gains and qualifying dividends will rise to 20% to the extent their income exceeds this level. the new dividend rate will apply to dividends received on unvested restricted stock for which an 83(b) election has been filed. Taxpayers with income over this level are also subject to the new 3.8% tax on net investment income and the new limitations on itemized deductions and personal exemptions.

IMPACT OF NEW 2013 FEDERAL TAX RATES ON STOCK OPTIONS AND OTHER EQUITY COMPENSATION

Social Security and Medicare Taxes

The temporary 2% reduction in the employee's portion of Social Security taxes was allowed to expire and has reverted to 6.2% applicable to wages up to $113,700 in 2013. Employer Social Security rates remain at 6.2% plus 1.45% for Medicare. Self-employed persons also benefited from the 2% temporary reduction in the Social Security and its expiration results in reversion of the Self-Employment tax (Social Security and Medicare) to 15.3% (before the additional Medicare tax described below).

Taxpayers with income over $200,000 ($250,000 for joint returns)

For employees with income above this level, the employee portion of Medicare taxes increases by 0.9% to 2.35%. Self-employed taxpayers with income above this level will also be subject to an additional Medicare tax of 0.9%.

Alternative Minimum Tax

The annual AMT "patch" is permanently indexed for inflation beginning in 2013 but did not extend the refundable AMT credit after 2012.

Application to Various Types of Income

- Salary, bonuses, nonqualified stock option gains and income on the vesting of restricted stock are all ordinary income, subject to the top federal rate of 39.6% plus the 2.35% Medicare tax, or a total of 41.95%.
- Gain on the sale of stock will have a top federal tax rate of 23.8% (20% capital gains and the new 3.8% tax on investment income) even if long term capital gains (if short term, it would be 43.4%).
- Dividends (if qualifying) on stock holdings would have a top federal rate of 23.8%.

Withholding on Supplemental Income

- Federal withholding on supplemental income, such as equity compensation, is subject to two flat rates linked to tax rates. For supplemental wage payments aggregating up to $1 million a year, the rate is 25%. For supplemental wage payments aggregating in excess of $1 million, the rate is 39.6%, the same rate applicable to income in the highest tax bracket.

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RECENT DEVELOPMENTS AFFECTING GLOBAL STOCK PLANS

by Scott E. Landau and Bradley A. Benedict

As noted in Pillsbury's May 12, 2011 Advisory, *Going Global with US Employee Stock Plans*, sponsors of global stock plans must navigate a host of legal and tax regimes to maintain compliance with applicable rules and laws. This article briefly discusses some recent developments in a number of countries that may have consequences for the administration, operation or design of such plans. The following is intended only to be a high-level summary of legislative changes and other events. Where relevant, companies should seek guidance in coordination with local counsel to evaluate the impact of these or other developments on their global stock plans.

France – "Qualified" Stock Options and Free Share Plans

In December 2012, France enacted tax legislation providing for significant changes to the rules governing "qualified" stock options and "free shares" (free shares are similar to stock-settled restricted stock unit plans). "Qualified" stock options and free shares are eligible for special tax treatment, provided that they are structured to comply with certain holding, vesting and other requirements.

Much of the tax benefit for the employee on French qualified awards has been eroded under the new rules, which apply to grants made on and after September 28, 2012. Income tax on qualified awards is now imposed at the prevailing progressive income tax rate (highest marginal rate 45%, not counting the surtax applicable to high earners), instead of the fixed rates of 18%, 30% or 41% that applied prior to the legislation. However, the grantee's social surtax charge has been decreased from 15.5% to 8%, along with the 10% social security contribution. On the company's side, the employer's social tax liability increased from 14% to 30%, effective for grants made on or after July 11, 2012. In light of the new tax regime, sponsors of French qualified share plans should reevaluate whether granting such awards continues to achieve the company's equity compensation objectives.

The legislation also contains new reporting requirements. Companies must issue a certificate containing details of the issuance to grantees by March 1 of the year following the year stock options are exercised, and they must provide certain data to the tax authorities with their employer annual wage information returns. Failure to comply with the reporting requirements can result in the company having to pay the social surtax charge for both the employer and the employee on the award.

As a result of technical changes under the law pursuant to the Constitutional Court of France, the holding period requirement for French qualified stock options (but not free shares) has been eliminated. Under the prior rules, shares obtained upon the exercise of a French qualified stock option had to be held for four years from the date of grant. It is possible that the French government may seek to restore the condition. In the meantime, plan sponsors may consider removing the holding requirement for French qualified stock options.

United Kingdom – Employee Shareholder Designation

On April 24, 2013, the UK government approved new legislation recognizing a new employment status: the "employee shareholder." The new law permits employees in the UK to give up certain statutory employment rights in exchange for receiving stock in their employer or its affiliates (including non-UK affiliates). While final implementation rules have yet to be issued, the main provisions of the program are as follows. The rights "employee shareholders" can forego include the right to pursue an unfair dismissal claim (other than for dismissals deemed automatically unfair or that relate to discrimination), statutory redundancy pay and rights concerning flexible working arrangements and time off for training, along with an extension of the time required to notify the company before returning from maternity, parental, paternity or adoption leave from 8 to 16 weeks. Among other requirements, individuals entering shareholder employee agreements must be afforded independent legal advice (at the employer's expense) and have a seven-day period to revoke. Employers may condition an offer of employment on the prospective employee's entering an employee shareholder arrangement, but active employees may not be punished for refusing to accept an offer to become an employee shareholder. The program will be effective for grants made on and after September 1, 2013. No income tax or National Insurance Contribution charge will apply for such shares up to the first £2,000 in value. In addition, up to £50,000 of such shares will be exempt from capital gains tax on disposal (in both cases, valued at the date of acquisition, without regard to any restrictions). The grant must be for fully paid-up shares having a value of at least £2,000, which may be subject to certain restrictions, such as company repurchase rights.

Singapore – Nonrenewal of ERIS Tax Benefits

The tax benefits under Singapore's Equity Remuneration Incentive Scheme (ERIS) are being phased out. ERIS provides for tax exemptions on a portion of the taxable gains incurred by recipients of qualifying compensatory equity awards, provided that certain vesting conditions and administrative requirements are satisfied. In particular, as it relates to global stock plans, the incentives for the "All Corporations" category of ERIS plans (including plans that issue non-Singapore parent stock to participants) will expire as of January 1, 2014. Equity awards that are granted on or before December 31, 2013 will continue to qualify for the beneficial tax treatment for gains that are derived on or before December 31, 2023. Companies may want to notify their Singapore employees if these changes affect their equity compensation and may want to reconsider their overall compensation structure in Singapore to the extent the ERIS phase-out affects the rationale for the equity based component of total compensation.

Philippines – Taxation of Employee Stock Options

In Revenue Memorandum Circular No. 88-2012 dated December 27, 2012, the Philippine Bureau of Internal Revenue (BIR) clarified the tax treatment of stock options granted to employees in certain situations. The BIR guidance provides that:

- Income or gain realized from the exercise of stock options granted to all employees is considered additional compensation, subject to income tax withholding.
- Such income or gain derived from the exercise of stock options granted to "managerial" and "supervisory" employees (essentially, individuals having authority to establish management policies, hire, discharge, discipline and otherwise manage employees or exercises independent judgment to recommend such managerial actions).
- The taxable amount is based on the difference of (A) the higher of the book value or fair market value of the shares, over (B) the price paid for the shares.

The additional compensation and, as applicable, taxable fringe benefit arises regardless of whether the shares involved are that of a domestic or foreign company. The BIR Circular did not address the issue of whether these rules apply if the Philippine entity does not record the expense in its books or does not ultimately bear the expense of the grant (e.g., through reimbursement of non-Philippine affiliate in a charge-back arrangement). Companies granting equity grants in the Philippines should examine their existing procedures for consistency with the recent guidance.

RECENT DEVELOPMENTS AFFECTING GLOBAL STOCK PLANS

Ongoing Management of Global Stock Plans

Equity-based compensation can be a fundamental tool for multinational organizations, but global stock plans face special challenges insofar as the tax, securities, employment, currency control and other laws in the relevant countries by necessity will have a significant impact on the structure and administration of the program. It is important for companies sponsoring global stock plans to keep abreast of developments not only for purposes of compliance with applicable law, but also to evaluate periodically the effectiveness of the program on a jurisdiction-by-jurisdiction basis and opportunities for improvement to help the company achieve its goals.

If you have any questions about equity compensation plans, including an existing or contemplated global stock plan, Pillsbury's Executive Compensation & Benefits group is happy to work with you, in coordination with counsel in the relevant local jurisdictions, to address these issues.

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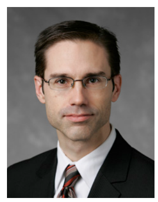

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NEW TAX INCREASES MAKE DEFERRAL OF COMPENSATION A (MORE) VALUABLE BENEFIT FOR MANY EMPLOYEES

by Howard L. Clemons

This article describes how the new additional Medicare tax, tax on net investment income, higher marginal tax rates, and phase-out and reductions of personal exemptions and itemized deductions make the use of compensation deferral techniques a potentially significant benefit to employees.

The combination of the new additional Medicare taxes on wages, additional taxes on certain investment income of higher income taxpayers, and the new higher marginal income tax rates on both ordinary income and capital gains make income deferral opportunities a potentially valuable benefit for many employees. Because many taxpayers are likely to be subject to these additional taxes or higher tax rates during some or all of their remaining working lives, yet not subject to some or all of these increased taxes in other years or following their retirement, managing the date of recognition of taxable income by use of available deferral techniques can produce actual tax savings. Consequently, many employees are now positioned to use tax deferral techniques to obtain actual reductions in taxes and not just deferral of taxes.

NEW ADDITIONAL TAXES OR INCREASED TAX RATES

To summarize, the new additional taxes or increased tax rates, which became effective on January 1, 2013, are as follows:

- An additional Medicare tax of 0.9% on wages in excess of $250,000 for married taxpayers filing a joint return and $200,000 for taxpayers filing single.
- An additional tax of 3.8% on most "net investment income" to the extent a taxpayer has modified adjusted gross income in excess of $250,000 for married taxpayers filing a joint return and $200,000 for taxpayers filing single.
- The highest marginal income tax rate on ordinary income has been increased to 39.6% on taxable income in excess of $450,000 for married taxpayers filing a joint return and $400,000 for taxpayers filing single.
- The long-term capital gains rate (and rate on qualified dividends) is increased from 15% to 20% for taxpayers with taxable income above $450,000 for married taxpayers filing a joint return and $400,000 for taxpayers filing single.
- The personal exemption of $3,800 begins to be phased out for taxpayers with adjusted gross income in excess of $300,000 for married taxpayers filing a joint return and $250,000 for taxpayers filing single. To illustrate the hidden effect of this provision, a married taxpayer filing jointly with two dependent children (so, four personal exemptions) and with $350,000 in adjusted gross income may appear to be subject to a marginal income rate of 33%, but the phase-out of personal exemptions effectively increases that marginal rate by about four percent to approximately 37%.

NEW TAX INCREASES MAKE DEFERRAL OF COMPENSATION A (MORE) VALUABLE BENEFIT FOR MANY EMPLOYEES

- Itemized deductions are reduced by three percent of the amount by which a taxpayer's adjusted gross income is in excess of $300,000 for married taxpayers filing a joint return and $250,000 for taxpayers filing single, with the reduction not exceeding 80% of the taxpayer's otherwise allowable itemized deductions. The practical effect of the itemized deduction limit is to raise the top tax rate of 39.6% by nearly 1.2% to almost 40.8%.

While each of these new or increased taxes kick in at different thresholds, they all present opportunities for better timing of income recognition to reduce taxes for many taxpayers.

OPPORTUNITIES FOR BETTER TIMING OF INCOME RECOGNITION

The lower tax rates in effect during the Bush tax cut years combined with the conventional (and correct) wisdom that rates would likely increase in the future made income deferral less attractive over the last couple of years and even encouraged acceleration of income recognition into 2012. Due to the relatively compressed tax brackets that prevailed and the prospect of higher future tax rates, many individuals and their advisors have operated on the assumption that deferral of taxable income might provide some limited benefit by virtue of the deferral but it would not result in the income being subject to a lower tax when it is finally taken into taxable income. However, the new tax regimes and the focus on both increased taxes and loss of itemized deductions and personal exemptions at income levels above certain threshold amounts now allow taxpayers who may be above the relevant thresholds in one year but not in later years to reduce their tax liability if they can better time the date on which recognition of taxable income occurs. In short, in many more situations than would have occurred before the new tax changes, deferral of income recognition may provide an actual savings in the amount of taxes due.

In addition to reducing federal taxes by deferring income into lower income years, a mobile taxpayer who retires from a high state income tax state to a low state income tax state or one of the nine states, such as Florida, Nevada or Texas, which either have no individual income tax or a limited individual income tax, may, depending on the method used for the deferral and the plan design, also achieve state income tax savings by virtue of deferral. In this respect, under federal law, an individual may be subjected to state income tax on distributions from a tax-qualified plan only by the state in which he or she is a resident or domiciled at the time of the distribution. A similar rule applies to payments from nonqualified deferred compensation plans if the payments from the plan are being made over a period of at least ten years or the plan meets other requirements.

It is worth noting that the 3.8% additional tax on net investment income is based on whether modified adjusted gross income exceeds the threshold amount. Thus, although an employee subject to the tax is nominally paying the tax on their net investment income, to some extent this is semantics. To the extent a reduction in the employee's current year wages by virtue of a deferral would reduce the employee's modified adjusted gross income below the income thresholds at which the 3.8% additional tax applies, the effect on the employee is a savings of the 3.8% additional tax. At least for the taxpayer whose modified adjusted gross income is tipping between the modified adjusted gross income threshold of $250,000 for a joint return or $200,000 for a single return, a decrease in either the taxpayer's net investment income or their wages results in a reduced liability for the 3.8% additional tax.

TAX DEFERRAL OPTIONS

But what can an employer or an employee do? Opportunities for tax deferral come in several forms. The most obvious, and best as we shall see below, are tax-qualified retirement plans, including 401(k) plans, profit sharing plans and, yes, even defined benefit pension plans. Certain incentive plans, such as stock option plans, inherently provide a tax deferral opportunity. Finally, nonqualified deferred compensation plans, where available, also provide opportunities for employees to defer the recognition of taxable income.

NEW TAX INCREASES MAKE DEFERRAL OF COMPENSATION A (MORE) VALUABLE BENEFIT FOR MANY EMPLOYEES

Tax-Qualified Retirement Plans

Of the three categories of deferral opportunities, tax-qualified retirement plans are clearly the best from several points of view: they provide a current tax deduction to the employer, they are funded in a trust so benefits are not subject to the employer's financial stability and, to top it off, the distributions when made, even if shortly after the contribution, are never directly subject to either the 0.9% additional Medicare tax or the 3.8% additional tax on net investment income or, for that matter, any other Social Security or Medicare taxes. And while tax-qualified retirement plans (or the rollover of these benefits to individual retirement accounts) are essentially tax deferral programs, they also commonly offer a participant significant flexibility on when to recognize taxable income. This flexibility obviously provides an individual with the opportunity to elect recognition of taxable income in his or her lower tax rate years. The combined effect of electing a lower tax rate year for income recognition together with avoidance of Medicare taxes may provide material tax savings in the right cases.

Many employers who sponsor tax-qualified retirement plans are currently unaware that various design techniques are available under current law, which permit the employer to increase contributions or benefits for certain groups of employees but not others. Many employers are under the impression that employer-funded contributions must be established at the same percentage of compensation for all plan participants or the plan will have a discriminatory structure which is not permitted. This is true for plans where the only employer contribution is a matching contribution. However, plans that provide for employer-funded contributions such as nonelective contributions (i.e., contributions made without regard to participants' contributions, such as discretionary profit sharing contributions), or plans which can be redesigned to redirect some of the existing employer contribution from a matching contribution to a nonelective contribution, can certainly have designs which provide higher contribution percentages for certain groups of employees. The amount of increased benefit which can be provided to the targeted group of employees by use of these techniques is dependent on a plan's current benefit structure for other participants and, in certain designs, the demographics of the plan participants. While almost any plan design providing employer-funded contributions can be adapted to take advantage of these plan designs, those employers which already provide relatively rich levels of benefits are uniquely positioned to take advantage of these plan designs targeting higher levels of contributions or benefits to certain employees.

Defined Benefit Pension Plan

While even the thought of a defined benefit pension plan and its related investment risk may send stockholders and corporate directors running, a newer hybrid form of plan, a market-return based "cash balance" pension plan, can provide a very significant level of employer-investment risk mitigation. In a case where the defined contribution plan structure has been maximized within the allowable allocation limits, alternative cash balance defined benefit plan designs may be considered. Although cash balance plans are defined benefit plans for funding and benefit limit purposes, they present the benefit accrued by a participant almost as if it were a defined contribution account. These newer hybrid plan designs are now quite common in financial institutions and professional services firms.

Stock Option or Stock Appreciation Rights

Stock option or stock appreciation rights as normally structured have the unusual benefit of allowing the employees to choose when they will be taxable. This form of compensation might not be something an employer would adopt as a tax saving measure for employees, but employees with these benefits should certainly be aware that they can be used to manage their income recognition dates and potentially reduce their tax liability. Employers might want to consider whether extended exercise periods for retiring employees are beneficial. Any benefit to a retiree of allowing an extended period to exercise would, however, need to be weighed against the fact that under current law an employee's and employer's liabilities for Social Security taxes (but not Medicare taxes), are limited to wages paid during a year which do not exceed the Social Security Wage Base ($113,700 for 2013), and an extended exercise period increases the likelihood that options may be settled in a year following the year during which the retiree was employed and received other wages from the employer.

NEW TAX INCREASES MAKE DEFERRAL OF COMPENSATION A (MORE) VALUABLE BENEFIT FOR MANY EMPLOYEES

Restricted stock and restricted stock units do not normally provide employees with flexibility regarding the timing of income recognition. Restricted stock is taxable not later than when the employee's rights become vested. Restricted stock units, which are actually just a nonqualified deferred compensation promise with the value of the benefit measured in stock value, can be structured to provide tax deferral because regardless of earlier vesting, the benefit is not taxable until paid to the employee. As with other nonqualified deferred compensation, which is discussed below, it is possible to provide employees with an opportunity to make a prior election regarding the payment date of the benefit. The timing of any such election has to comply with applicable rules, but the fact is that participant elections are possible.

Nonqualified Deferred Compensation

While other forms of deferred compensation outside of a tax-qualified plan under a so-called "nonqualified plan" may provide for similar benefits of deferral into lower tax rate years, under the Employee Retirement Income Security Act of 1974 (ERISA), these plans must generally be limited to a select group of management or highly compensated employees. Furthermore, the deferral into these plans must be what for tax purposes is treated as an "unfunded and unsecured" promise to pay. As a result, the employee is subject to credit risks of the employer. Even in those cases where the employer establishes and funds a grantor trust, commonly referred to as a "rabbi trust," the participating employees remain subject to risk of the employer's creditors in the event of the employer's bankruptcy or insolvency.

From a tax perspective, nonqualified plans must comply with a plethora of technical rules. All nonqualified deferred compensation plans must now comply with the rules of Section 409A of the Internal Revenue Code (the Code), nonqualified plans of tax-exempt employers must comply with Section 457 of the Code, and nonqualified plans of certain tax-indifferent entities, such as entities owned by either tax-exempt employers or entities which are foreign corporations not subject to comprehensive income taxes, must comply with Section 457A of the Code. Both Sections 457 and 457A contain substantial limits on the use of nonqualified deferred compensation by employers to which they apply. In such situations, a harder look at the ability to use tax-qualified deferred compensation becomes a higher priority. It is worth noting that nonqualified deferred compensation is generally subject to FICA taxation in the year of vesting.

Hence, the 0.9% additional Medicare tax will be saved only if the vesting occurs in a year when the employee's total wages, including the nonqualified deferred compensation (even if not yet income taxable) is below the applicable threshold of $250,000 for married filing jointly or $200,000 for single filers. Use of nonqualified deferred compensation is more likely to be helpful in avoidance of the 3.8% additional tax on net investment income for an individual near the tipping point for liability for the 3.8% additional tax since liability for that tax is based on modified adjusted gross income.

While Section 409A of the Code, the tax provision applicable to all nonqualified deferred compensation plans, generally requires that deferrals be established before the beginning of each year, for an employer without an existing nonqualified deferred compensation plan for which an employee is eligible, it is not too late to establish a new plan for that employee for 2013; an employer without an existing plan for an employee may establish a plan mid-year. Also, even for existing plans, employee elections to defer performance-based bonuses meeting certain requirements may be made mid-year. Regardless of whether an employer is a cash or accrual method taxpayer, an employer providing nonqualified deferred compensation plan may not recognize a tax deduction until the nonqualified deferred compensation is actually paid to the employee. In most cases the "cost" to the employer of this delay in recognition of its tax deduction for nonqualified deferred compensation will be that the tax savings derived from the deduction will be received at a later date, rather than an actual tax rate differential, as is the case for the employee side of the deferral. Because nonqualified deferred compensation plans are subject to claims of the employer's creditors, these plans are best used when long-term outlook for the employer's financial health is strong.

CONCLUSION

In summary, the new additional Medicare tax, tax on net investment income, higher marginal tax rates, and phase-out and reductions of personal exemptions and itemized deductions make the use of compensation deferral techniques a potentially significant benefit to employees. Employers should consider reviewing their compensation plans and programs in light of the new tax laws.

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