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EXECUTIVE COMPENSATION IMPLICATIONS OF CHANGES IN TAX LAW

Tax law changes signed into effect on August 5, 1997 by President Clinton include a reduction in the capital gains rate and a gradual increase in the unified credit that provides a shelter against Federal estate taxes.

While all Americans may potentially benefit from these and other tax law changes adopted as part of the Taxpayer Relief Act of 1997, the most significant influence on executive compensation planning will likely be the reduction in capital gains tax rates.

POTENTIAL EXECUTIVE COMPENSATION IMPLICATIONS OF CAPITAL GAINS TAX CUTS

Under prior law, investment gains on capital assets held for more than one year were taxed at an individual's marginal Federal tax rate, to a maximum of 28%. The new law makes significant changes to the capital gains tax for sales made after May 6, 1997 by:

- Maintaining the 28% maximum rate for investments held more than one year, but reducing the rate to 20% for investments held more than 18 months
  - 20% rate does apply, however, to assets held 12 months if sold during transition period (May 7 through July 28)
- Providing a further reduction in the maximum rate to 18% for investments purchased after the year 2000 and held at least five years.

For taxpayers in the lowest Federal tax bracket, the capital gains rate is further reduced to 10% for sales of investments held 18 months and to 8% for five-year investments made after 2000.

Reduction in the maximum capital gains tax will directly impact the relative value and

prevalence of several grant types, arrangements, and strategies commonly used in executive compensation programs.

Incentive Stock Options (ISOs)

The use of ISOs becomes more attractive since the reduction in the maximum capital gains rate enhances the potential value to executives relative to the cost to the company.

Executives receive favorable tax treatment on stock acquired through the exercise of an ISO if the acquired stock is held for at least two years after the grant date and one year after exercise. Assuming these conditions are met, there is no ordinary income tax at exercise and the entire gain is taxed at long-term capital gains rates when the shares are sold.**Footnote1** The *quid pro quo* for ISOs' more favorable individual tax treatment is the loss of the corporation's tax deduction that would otherwise generally be available upon exercise of nonqualified stock options (NSOs).**Footnote2**

Due to the lost tax deduction, ISOs have always been an inherently more expensive method of delivering an equivalent after-tax benefit. However, reduction in the capital gains rate will decrease the corporate cost of delivering each incremental dollar of after-tax employee benefit, as illustrated in the following example.

> Assume an option covering 5,000 shares is granted with a $20 exercise price, the option is exercised after five years when the stock price is $32.25, and the underlying shares are sold two years later at $39.00. The following table illustrates the net after-tax benefit to the executive under the new and old capital gains rates, assuming shares are withheld for taxes (at 39.6%) and the exercise price is paid in cash:

	New Law		**Old Law**	
Benefit to Executive	**NSO**	**ISO**	**NSO**	**ISO**
(a) Number of Shares	5,000	5,000	5,000	5,000
(b) FMV at Exercise	$32.25	$32.25	$32.25	$32.25
© Exercise Price	$20.00	$20.00	$20.00	$20.00
(d) Gain Per Share (b - c)	$12.25	$12.25	$12.25	$12.25
(e) Aggregate Gain (a x d)	$61,250	$61,250	$61,250	$61,250
(f) Taxes (e x .396)	$24,255	$0	$24,255	$0

(g) Profit After Taxes (e - f)	$36,995	$61,250	$36,995	$61,250
(h) Shares Withheld For Taxes (f/b)	753	0	753	0
(i) Remaining Shares (a - h)	4,247	5,000	4,247	5,000
(j) FMV at Sale	$39.00	$39.00	$39.00	$39.00
(k) Value of Shares Sold (I x j)	$165,633	$195,000	$165,633	$195,000
(l) Tax Basis of Shares (NSO: I x b) (ISO: a x c)	$136,966	$100,000	$136,966	$100,000
(m) Pre-Tax Capital Gain (k - l)	$28,667	$95,000	$28,667	$95,000
(n) Capital Gains Rate	20%	20%	28%	28%
(o) Capital Gains Tax (m x n)	$5,733	$19,000	$8,027	$26,600
(p) Capital Gains After Tax (m - o)	$22,934	$76,000	$20,640	$68,400
(q) Initial After-Tax Gain at Exercise (g*)	$36,995	N/A	$36,995	N/A
Total Gain After Tax	**$59,929**	**$76,000**	**$57,635**	**$68,400**

* NSOs only; no taxation at exercise on ISOs

Based on the above, the ISOs provide a net tax advantage of $16,071 ($76,000-$59,929) under the new law as compared to $10,765 under the old ($68,400-$57,635). However, this tax advantage comes at a cost of $21,438 to the corporation that would otherwise be available on NSOs in the year of exercise, assuming a 35% corporate income tax rate ($61,250 x .35). Or in other words, the reduction in capital gains tax has reduced the incremental corporate cost of providing each additional dollar of employee benefit under the ISO scenario from $1.99 to $1.33, as illustrated below:

Corporate Cost of Incremental Executive Tax Benefit

	New Law	**Old Law**
Net Benefit to Executive (a)	$16,071	$10,765
Cost to Corporation (b)	$21,438	$21,438
Cost Per Incremental Dollar (b/a)	$1.33	$1.99

While ISOs become more attractive as a result of reduction in capital gains rates, they are still not as cost effective as NSOs and we do not expect a significant increase in their use.

Restoration (Reload) Stock Options

The potential value of a reload feature on a stock option is increased since the potential tax benefits of early exercise are magnified by the capital gains tax reduction.

In its most basic form, a restoration stock option provides that when an executive exercises an option by actually or constructively tendering shares already owned, the options exercised are immediately replaced, or reloaded, with a number of options equivalent to the number of shares tendered to pay the exercise price. The reload grant carries a term equal to that remaining on the options that were exercised and an exercise price equal to the current fair market value (FMV).

The reload feature does not change the executive's total carried interest (i.e., sum of shares directly owned and those under option), but rather rebalances the portfolio to increase the portion attributable to shares directly owned. While the intent of the reload feature, or rebalancing, is to encourage greater direct ownership interest through early exercise, it also means that a larger portion of the total gain is likely to be taxed as a capital gain, rather than as ordinary income. This is because a larger portion of the executive's carried interest is composed of directly owned shares, which provides a potential tax benefit to the executive, as illustrated below.

Assume an executive owns 5,000 shares of stock acquired at $50 per share, is granted an option on 10,000 shares when the FMV is $50 per share, liquidates his entire carried interest at the expiration of the 10-year option term, and is subject to the 20% capital gains tax and a marginal rate of 39.6% on ordinary income:

- Plan vanilla options--if the FMV of the stock increases to $200 per share over the 10-year option term, the total pretax gain on the executive's 15,000 share carried interest would be $2.25 million, and net after-tax profit would be $1,506,000, as illustrated below:

Gain on Option Exercise	$1,500,000	(10,000 x ($200-$50))
Ordinary Income Tax	$594,000	($1,500,000 x .396)
Net After-Tax Gain(a)	**$906,000**	
Gain on Shares Directly Held	$750,000	(5,000 x ($200-$50))
Capital Gains Tax	$150,000	($750,000 x .20)

Net After-tax Gain(b)	**$600,000**
Total Net-After-Tax Gain(a + b)	$1,506,000

- Reload stock options--if an identical option was granted, but with a reload feature, the transaction would occur in two parts. If exercise occurred after five years by tendering the 5,000 already-owned shares when the FMV was $100, the executive would own 10,000 shares and receive a reload option grant on 5,000 shares with an exercise price of $100 and a term of five years (note that the example assumes taxes are paid in cash, rather than by selling shares). If the FMV increases to $200 per share over the next five years and the executive exercises the 5,000 share reload grant, total pretax profits on this series of transactions also equals $2.25 million, with a net after-tax gain of $1,604,000, as illustrated below:

Gain on Initial Option Exercise	$500,000	(10,000 x ($100-$50))
Ordinary Income Tax	$198,000	($500,000 x .396)
Net After-Tax Gain(a)	**$302,000**	
Gain on Final Option Exercise	$500,000	(5,0000 x ($200-$100))
Ordinary Income Tax	$198,000	(500,00 x .396)
Net After-Tax Gain(b)	**$302,000**	
Gain on Shares Directly Held		
Initial Shares @ $50 basis	750,000	(5,000 x ($200-$50))
Reload Shares @ $100 basis	500,000	(5,000 x ($200-$100)
Total Amount Subject to Capital Gains Tax	1,250,000	
Capital Gains Tax	$250,000	($1,250,000 x .20)
Net After-Tax Gain(c)	**$1,000,000**	
Total Net After-Tax Gain(a + b + c)	$1,604,000	

The after-tax value of the reload scenario exceeds that of the plain vanilla grant scenario by $98,000, or in other words, by about 6.5%. Under the prior law, the incremental value realized under the reload scenario would have been only $58,000, or about 4% of the after-tax value of the plain vanilla grant scenario.**Footnote3**

We expect that stock options that contain a reload feature will continue to grow in

prevalence, and the reduced capital gains tax enhances the efficiency of this instrument.

Nonqualified Deferred Compensation Arrangements

Nonqualified deferred compensation plans may become less attractive to some executives, but only to the extent that executives believe they can earn significantly higher rates of return outside the plan.

While distributions from deferred compensation plans are subject to taxation as ordinary income, investments made outside the plan are eligible for favorable capital gains taxation based on the length of the holding period. Despite the increase in the difference between the highest marginal rates on ordinary income and the capital gains rate, deferred compensation still remains a very attractive device from a tax standpoint due to the effect of pretax compounding of investment earnings.

> For example, an executive who elects to defer $25,000 annually over a five-year period will generate a net after-tax benefit of $92,061, assuming contributions are invested at mid-year, an annual investment credit of 8%, and a 39.6% marginal rate on ordinary income. Had the same executive elected to receive cash, the net after-tax value would be only $88,694 (or about 96% of the net after-tax benefit in the deferral scenario) assuming the after-tax value was invested each year in securities that grow in value at an 8% rate and a capital gains tax of 20% applied to the appreciation. The difference grows even larger if the same scenario is extended over a longer period of time (i.e., to $426,081 vs. $385,913 over a 15-year period, or about 91% of the net after-tax benefit in the deferral scenario). **Footnote4**

However, the above scenario may not hold true if an executive believes that a higher rate of return could be earned outside the deferral program. Over the 15-year period described above, the net after-tax value of investments made outside the plan that grow at 9.5% annually would be $430,955, or slightly more than the net after-tax value of contributions and interest credited in the deferral plan that credits only 8%.

We expect that nonqualified plans that credit deferrals with only a fixed investment return will be expanded to include deferred stock unit accounts and/or other potentially higher yielding alternatives.

Section 83(b) Elections

The potential value of making a Section 83(b) election, relative to the risk of overpaying taxes, is increased by the reduction in the capital gains tax rate.

Under ordinary circumstances, restricted stock grants are taxed as ordinary income in the year the restrictions lapse based on the excess of the fair market value over the price, if any, paid by the executive. However, Section 83(b) of the Internal Revenue Code allows an executive to elect to be taxed at the fair market value at the time of grant, so any post-grant appreciation is taxed as a capital gain at sale.

Section 83(b) elections are rare due to the modest benefit of capital gains rates and the risk of a tax overpayment if the restrictions fail to lapse or if the stock fails to increase in value at a rate that compensates for the accelerated tax payment. While the widening of the gap between capital gains and ordinary income tax rates increases the potential net after-tax value of a Section 83(b) election, *we do not expect a significant increase in Section 83(b) elections, except in cases where the executive expects the return on the shares to significantly outpace the time value of money used to pay the up-front tax.*

Other Possible Implications

Some other potential implications associated with reduction in the capital gains rate include:

- Use of stock in lieu of cash--reduced capital gains rates will likely encourage use of stock in lieu of cash bonuses paid to executives and cash retainers and fees provided in nonemployee director programs. It might also increase the prevalence of programs in which executives and outside directors are permitted to trade cash for stock compensation (with and without premiums in the form of tax gross-ups and/or additional shares).

- Golden parachutes--as illustrated in the above examples, reduction in capital gains rates will potentially raise annual W-2 compensation by encouraging early exercise of stock options (e.g., reloads), etc. This will have the effect of raising the base amount for determining the amount of excess parachute payments made to executives in the event of change in control. The base amount is defined as the 5-year average W-2 compensation, and parachutes valued in excess of 2.99 times this amount are subject to the penalties. Each additional dollar of W-2 compensation earned in any given year during the base period will raise the base amount by $0.20, which will effectively result in sheltering $0.60 of parachute income in determining whether or not there are excess parachute payments.

POTENTIAL IMPLICATIONS ON ESTATE AND FINANCIAL PLANNING

- Transfer of stock options--the new tax law gradually raises the unified estate and gift tax credit from its current level of $192,800. The current credit amount provides an effective exemption from estate taxes of $600,000. The increase is phased in beginning in 1998 to a maximum effective exemption of $1 million in 2006 and thereafter. While this change should theoretically reduce pressure to allow transfer of stock options, it is likely to have little impact on executives whose estates are still subject to substantial taxes at death. In effect, by focusing more attention on the issue, the increase in the unified credit could actually increase demand for transferable options.

- Financial planning--increased demand for executive financial and tax planning services could result from the complexities associated with the tax law changes, which will create the need to rethink strategies regarding option exercise, how much compensation to defer and in what form, how to plan around the Alternative Minimum Tax, estate and gift-tax planning, and other related issues.

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As the tax law worked its way through Congress, compensation professionals examined the potential impact of the changes on various aspects of executive pay. While the *relative value* of many compensation tools is affected by changes in the tax law, these changes do not, for the most part, fundamentally affect best practice in executive compensation planning. However, we see these changes as positive since they increase the potential value of certain compensation vehicles and should help to support increased levels of direct company ownership among top executives, which will further align executive interests with those of shareholders.

Questions on this letter can be addressed to Dan Ryterband in the New York Office at (212) 986-6330, or to any other member of our firm. Copies of this letter and other published materials are available on our web site, WWW.FREDERICWCOOK.COM.

Footnote1

In contrast, gains on nonqualified stock options are taxed at exercise based on an individual's ordinary marginal tax rate, with subsequent gains taxed as either ordinary income or capital gain based on holding period; note that gains on ISOs are considered a tax preference item subject to Alternative Minimum Tax.

Footnote2

The company is permitted a tax deduction on the amount recognized as taxable income by the executive upon exercise of NSOs.

Footnote3

Note that this example does not consider the time value of money associated with early exercise and payment of taxes in cash or the net after-tax value of dividends received on the additional shares directly owned. Assuming a net after-tax return of 5%, the opportunity cost of the up-front cash outlay for taxes would be approximately $9,900 per year ($198,000 x .05). However, depending on the dividend yield, some or all of the opportunity cost would be offset due to early receipt of dividends. Assuming a constant 2% dividend yield and an average stock price over the 5-year period of $150, the net after-tax value of the dividend stream would be approximately $9,060 per year (5,000 shares x $150 x .02 x .604).

Footnote4

Also note that, while the reduced capital gains rate lessens the comparative advantage of deferring stock option gains relative to receiving actual shares, option gain deferral continues to be attractive in a similar manner.