The Contemporary Tax Journal

Volume 11
Issue 1 *The Contemporary Tax Journal Volume 11, No. 1 – Winter 2022*

Article 5

2-2-2022

An Introduction to the Tax Intricacies of Executive Compensation

Jane Lei CPA
San Jose State University

Recommended Citation
Lei, Jane CPA (2022) "An Introduction to the Tax Intricacies of Executive Compensation," *The Contemporary Tax Journal*: Vol. 11 : Iss. 1 , Article 5.
https://doi.org/10.31979/2381-3679.2022.110105 https://scholarworks.sjsu.edu/sjsumstjournal/vol11/iss1/5

An Introduction to the Tax Intricacies of Executive Compensation

By: Jane Lei, CPA, MST Student

Executive compensation is a multi-faceted and complex topic, engulfed in acronyms and legalese and frequently involving confounding numbers that boggle the minds of those on the outside. Just think of Elon Musk's headline-grabbing series of sales of Tesla (TSLA) shares which he started in November 2021. In a tweet[1], Musk famously solicited input from his 60+ million Twitter followers on whether he should sell some of his TSLA stock, adding that he will abide by the results of the poll. He has since sold over $10 billion worth of shares (as of the date of writing this article) with more sales expected to come, as he reportedly faces a $15 billion tax bill on TSLA stock options that are set to expire in the coming months.

Interestingly, the way Musk has sold TSLA stock led some Twitter users to dissect his sale transactions, specifically his rationale for selling existing common stock as opposed to exercising stock options and selling a portion of those shares instead. One Twitter user openly wondered whether Musk was trying to increase his tax liability, noting "… *Possible he's selling existing common shares to increase the taxes he's giving to the government, Would be kind of crazy but something Elon might do*."[2] In typical Musk fashion, the Tesla executive responded to confirm the observation in a tweet: "*A careful observer would note that my (low basis) share sale rate significantly exceeds my 10b (high basis) option exercise rate, thus closer to tax maximization than minimization*."

Exercising stock options triggers ordinary income tax. Often, such exercises will be transacted on a "cashless basis," with a portion of the exercised shares sold immediately to cover the recipient's income tax liability. Selling existing common stock shares to cover the tax liability of an options exercise seems counter intuitive as additional capital gains tax will apply on those sales.

It certainly isn't an everyday occurrence to see someone seemingly intentionally trying to pay more taxes. Per the company's 2021 proxy statement[3], Musk, as the company's chief executive officer, historically earned a minimum wage base salary. He never accepted the cash salary, and

---

[1] Elon Musk (@elonmusk), "Much is made lately of unrealized gains being a means of tax avoidance, so I propose selling 10% of my Tesla stock. Do you support this?", November 6, 2021, 12:17 p.m., https://twitter.com/elonmusk/status/1457064697782489088.

[2] Dave Lee (@heydave7), "Never heard that cost basis determines which shares need to be sold. I think he can choose which shares to sell. Possible he's selling existing common shares to increase the taxes he's giving to the government. Would be kind of crazy but something Elon might do." November 13, 2021, 2:38 p.m., https://twitter.com/heydave7/status/1459654348804403200.

[3] Tesla, Inc. Schedule 14A, Proxy Statement for 2021 Annual Meeting of Stockholders, https://www.sec.gov/Archives/edgar/data/1318605/000156459021045926/tsla-def14a_20210826.htm.

it was eventually eliminated by the company at his request. All of Musk's compensation from Tesla has been equity-based and tied to the company's performance. The shares in question that are set to expire in 2022 were granted in 2012 as performance-based stock option awards. According to the company's disclosures in its proxy statement, Musk beneficially owned 244,018,640 shares, or 23.1 percent, of the company's common stock as of June 30, 2021. This included common stock outstanding and common stock subject to options and other convertible securities.

While Musk is not your typical executive and the magnitude of his compensation arrangement is certainly extraordinary, by any standard, executive compensation has been soaring and has reached unheard of heights in recent years. How many of us can even dream of compensation in the millions, let alone billions, of dollars?

Executive Compensation – Why is it important?

A well thought out executive compensation plan helps companies attract, reward, and retain its key employees and motivate them by aligning their compensation with the company's goals to ultimately create shareholder value. It is arguably one of the most important factors in an organization's success. Beyond the need to be competitive and to drive performance, an executive compensation program must operate within the confines of tax rules and regulations and compliance requirements. And, especially with large, public corporations, executive compensation is often subject to intense public scrutiny. Compensation that is perceived to be excessive may incur the wrath of negative public opinion, although there are no bright-line rules that define what would constitute "reasonable" compensation.

Understanding the laws will help companies and executives navigate the complexities to plan for and maximize their tax efficiency. Because of the variety and intricacies of executive compensation arrangements, both the business and the executive should research available options thoroughly to optimize their respective situations.

An executive compensation package generally includes at least some, if not all, of the following components:

- a base salary,
- annual or short-term incentives (bonus),
- deferred or long-term compensation including retirement savings benefits,
- benefits and perquisites (or "perks" such as subsidized health insurance, business travel and meals).

Unlike for most other employees, a large portion of an executive's compensation, generally the portion that's deferred, is at-risk. This means that it is subject to specific conditions, such as the completion of requisite service periods or the achievement of performance objectives. Hence, if the executive's performance and/or that of the company fail to meet expectations or plans don't materialize, the executive may only receive a fraction of their potential pay. While

https://scholarworks.sjsu.edu/sjsumstjournal/vol11/iss1/5
DOI: 10.31979/2381-3679.2022.110105

deferring compensation does not eliminate the payment of taxes, it does defer the obligation to pay income taxes to a future period. As far as tax planning goes, the deferred components of an executive compensation package will undoubtedly have the most compelling opportunities for the executive. The impact of deferrals can be significant, if one can adjust the timing of income to minimize her or his ultimate tax liability. The most common rationale for deferral is when the recipient expects to be in a lower tax bracket in a future year, in which case, tax deferral would be a great tax planning tool.

Generally, cash compensation is taxable to the employee or service provider in the year it is received. Transfers of stock or other property is taxed in the same manner based on its fair market value ("FMV"). Employers may take a tax deduction for compensation in the year it is paid to, received, and recognized as income by the recipient. However, what about compensation to which an executive has a legally binding right but has not technically been received by the executive? This article seeks to highlight some of the key tax implications and planning considerations pertaining to executive compensation, both from the corporate employer's as well as the executive's perspective.

Section 162(m) - $1 Million Deduction Limit

For starters, section 162(m) of the Internal Revenue Code (IRC) imposes a $1 million per year limit on the deductibility of compensation paid to certain "covered employees" of publicly traded corporations. "Covered employees" are defined in section 162(m)(3) as the principal executive officer, the principal financial officer, and anyone who served in either role during the taxable year, as well as three other highest-paid employees of the company. Per the rules, any individual who was a covered employee for a tax year beginning after December 31, 2016, will remain a covered employee for all subsequent taxable years. This essentially means that an employee's status as a covered employee will never cease, even if she or he no longer works for the company or is no longer among the five highest paid employees of the company, and any compensation, including post-termination compensation in excess of $1 million per year paid by the company to the individual, will not be deductible and will effectively be subject to the corporate tax of 21% (i.e., current corporate tax rate). The American Rescue Plan Act (P.L. 117-2, 3/11/21) expanded the term "covered employees" to include an additional five of the highest paid employees for tax years beginning after December 31, 2026.

Since the enactment of the Tax Cuts and Jobs Act in 2017 ("TCJA"), the remuneration subject to the $1 million deduction limit has included qualified performance-based compensation, which was previously exempt from the deduction limitation. The TCJA includes a clause, however, that allows certain written binding employment agreements, in effect as of November 2, 2017, to be grandfathered under the old rule so long as they have not been materially modified or renewed since that date. Proper recordkeeping is key to tracking and substantiating payments to employees under grandfathered agreements year over year through retirement to ensure those payments can be deducted beyond the $1 million limit.

Section 409A – Income Tax Treatment of Nonqualified Deferred Compensation

IRC section 409A governs nonqualified deferred compensation ("NQDC") arrangements. The code stipulates that, if at any time during a taxable year, a nonqualified deferred compensation plan fails to meet the provisions under section 409A, all compensation deferred under the plan shall be included in taxable income of the employee or service provider for the year with an additional 20 percent excise tax imposed on that income. Potential late payment penalties and interest on the taxable amount, all payable by the recipient of the deferred compensation, may also apply. Section 409A is complex and far-reaching and can affect the design of benefit programs, severance pay arrangements, and employment agreements to name a few.

To comprehend section 409A, it is important to understand the principle of constructive receipt. Income is taxable upon its constructive receipt by the employee. To avoid constructive receipt, the compensation must be subject to substantial risk of forfeiture. In other words, "*entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial*."[4] When compensation is no longer subject to substantial risk of forfeiture, it is deemed to be vested.

Deferred compensation, on the other hand, is compensation that is earned in one year but paid out in a later year, i.e., an employee or service provider has a "*legally binding right during a taxable year to compensation that, pursuant to the terms of the plan, is or may be payable to (or on behalf of) the service provider in a later taxable year*."[5] Certain exemptions are provided, including one for short-term deferrals.[6]

At a high level, the difference between qualified and nonqualified plans is that qualified[7] plans, such as 401(k) plans, are generally intended to provide benefits to a broad scope of employees. A trust must be established for a qualified plan and is funded by contributions made by either employer or employee. In contrast, an unfunded NQDC plan does not have its own, separate trust set up and the funds for deferred compensation are intermingled with and paid out of the employer's general assets, which have little to no protection from the employer's general creditors and would be subject to a creditor's claim in the event of the company's insolvency.

NQDC plans serve as an important tool to set compensation for executives apart from compensation for regular employees. Unlike with qualified plans, a corporation has greater flexibility in the design of NQDC plans. Specifically, corporations can discriminatorily select which of its employees may participate in such plans, and deferrals from contributions to NQDC plans are unlimited. Examples of NQDC plans include employer-owned life insurance policies and supplemental executive retirement plans, or SERPs.

---

[4] IRC Reg §409A-1(d)(1).
[5] IRC Reg §1.409A-1(b)(1).
[6] IRC Reg §1.409A-1(b)(4).
[7] IRC §401(a).

https://scholarworks.sjsu.edu/sjsumstjournal/vol11/iss1/5
DOI: 10.31979/2381-3679.2022.110105

For compensation earned under a NQDC plan that complies with the provisions of section 409A, the income tax liability may be deferred to a future date. Specifically, those provisions are:

- The plan must be in writing.
- At the time an amount is deferred, the plan document(s) must specify:
    - the amount to be paid,
    - the payment schedule, and
    - the triggering event(s) that will result in payment.[8]
- The employee must make an irrevocable election to defer compensation before the year in which the compensation is earned. There are generally no provisions for early withdrawal and no acceleration of payment is possible.

While income tax is deferred until the amounts are actually paid out to the recipient (i.e., constructive receipt), employment tax (i.e., social security and Medicare) applies at the time of vesting. However, because participants of such nonqualified deferred compensation plans are often highly compensated employees, their wages are usually well above the social security wage base such that the Medicare tax may be the only employment tax that applies during the year of vesting.

By the same token as income tax is deferred for participants, employers may not take a current deduction on their contributions to NQDC plans until the benefits are paid out to participants and the participants are taxed on them. Further, any investment earnings under the plans are taxed currently to the employer rather than being compounded on a tax-deferred basis.

Section 409A and equity-based compensation

NQDC that's subject to section 409A also includes stock-based compensation, specifically restricted stock units, phantom stock and the like, as these represent an unsecured, unfunded promise by the employer to grant a set number of shares of stock or pay their cash equivalent to the employee or service provider upon the satisfaction of set performance criteria. Nonqualified stock options ("NSOs") and stock appreciation rights (SARs) are also NQDC if they are granted at an exercise price below FMV. To avoid taxation at the time of grant, they must meet the provisions of section 409A discussed earlier. It is important to note that stock rights, including stock appreciation rights, do not provide for a deferral of income as they are not subject to a substantial risk of forfeiture under Reg § 1.409A-1.

To provide some context, section 409A was codified in 2005 on the heels of years of corporate mishandling of deferred compensation plans, most notably in the case of Enron, which saw

[8] IRC §409A(a)(2)(A) prescribes five permissible payment events in addition to scheduled distributions, including the employee's separation from service, disability, or death, a change in ownership or control of the corporation, and the occurrence of an unforeseeable emergency. Also see IRC Reg §1.409A-3.

their executives accelerate the payout of their deferred compensation on the eve of the company's ultimate demise. In addition to preventing exploitative payment acceleration, section 409A also sought to address the then common practice for companies to give employees options to purchase stock that were already "in the money," i.e., options with a strike price lower than the FMV of the underlying stock at the time of grant. For example, if the share of stock in a company is worth $10, but the company provides for an option to buy the stock for $8, there is $2 of value that the employee is receiving immediately and that the government will want to tax. For stock option grants to be treated as tax-free events to a company's employees, the exercise price of an option must be set at or above FMV, and the company will be required to prove that the FMV applied is reasonable.[9]

Specifically, for privately held companies whose stock is not actively traded, the FMV of the stock may not be readily determinable. A valuation is required when private companies grant equity awards to their employees, including founders, to determine the proper exercise price for an option. In the past, a company would have decided on its own what they felt was an appropriate price. Post section 409A, a proper valuation requiring substantial supportable evidence is required. An updated valuation must be obtained every twelve months or earlier if there was change in the business that may have materially affected the value of the corporation. Determining whether there has been a material change that may have rendered a company's current valuation obsolete can be subject to significant judgment and companies would be well advised to seek legal counsel and appropriate valuation expertise. Probably the most common event that would affect a startup company's valuation is the injection of new capital. However, other events, such as the launch of a new product, macro-economic changes (e.g., due to COVID), or an unexpected entry into a material contract may also require a new valuation study to be conducted for a company.

Per the regulations, valuations must be performed by an independent appraiser with significant experience, which generally means "*at least five years of relevant experience in business valuation or appraisal, financial accounting, investment banking, private equity, secured lending, or other comparable experience in the line of business or industry in which the service recipient operates*."[10]

Equity-based compensation exempt from 409A

Section 409A does not apply to certain statutory stock options including incentive stock options ("ISOs"). To qualify as ISOs, stock options must satisfy the requirements under section 422, including but not limited to:

- Option may only be granted to employees.
- Option (exercise) price may not be less than the FMV of the stock when granted (110% of FMV if granted to employees who are 10% shareholders).

[9] IRC Reg §1.409A-1(b)(5)(iv)(B)
[10] IRC Reg §1.409A-1(b)(5)(iv)(B)(2)(iii).

DOI: 10.31979/2381-3679.2022.110105

- FMV of options vesting during a year may not exceed $100,000 (any other options vesting will be treated as NSOs.

ISOs offer preferential tax treatment for employees. No compensation is recognized at the time of grant or exercise of an ISO and the employer receives no tax deduction for the compensation. While no income tax applies on the grant or exercise of the option, the difference between the FMV and the exercise price is treated as income for purposes of calculating the employee's alternative minimum tax.

Because of the $100,000 limitation, ISOs are less prevalent than NSOs when it comes to executive compensation. In a qualifying disposition where holding period requirements are met (i.e., employee holds stock for at least two years from the date of grant and one year from the date of exercise), the entire gain on sale may be taxed as long-term capital gains. In a disqualifying disposition where holding period requirements are not met, the compensation is considered wages and is deductible by the employer. As with ISOs, section 409A also does not apply to stock options granted under an employee stock purchase plan (ESPP). However, since the purpose of an ESPP is to encourage employee ownership of company stock on a broader level and less relevant for executive compensation, this article will not delve further into the mechanics of ESPPs. It is worth noting that employment taxes (i.e., FICA, FUTA and FITW) do not apply on the exercise of an ISO or ESPP option, irrespective of whether the exercise was a qualifying or disqualifying disposition.[11]

Section 83(b) – Special Election on Restricted Stock

Section 83(b) provides the recipient of property, which includes restricted stock, the option to elect to accelerate her or his tax liability by paying taxes on the total FMV of the restricted stock at the time of the grant rather than upon vesting. A section 83(b) election, if made, must be within 30 days after the date of grant of the restricted stock.[12]

In effect, with a section 83(b) election, the recipient may pay ordinary income tax on a low valuation if the value of the equity is expected to increase in future years. This also allows the recipient to start the clock for the long-term capital gains holding period earlier, so that any appreciation between grant date and vesting date is taxed at the applicable capital gain rate instead of the ordinary income tax rate. However, if the value of the share declines in future years or the shares are forfeited, the employee may end up being negatively impacted. If the restricted stock is subsequently forfeited, the forfeiture is treated as a sale of the shares in exchange for no consideration. Further, the recipient is not entitled to a deduction or credit for taxes paid as a result of the section 83(b) election paid or the subsequent forfeiture of the property.[13]

[11] Notice 2002-47.
[12] IRC §83(b)(2).
[13] IRC §83(b)(1), IRC Reg §1.83-2(a).

Section 280G – Golden Parachute Payments

The last item to consider is compensation paid to executives under section 280G, aptly titled "golden parachute payments" to characterize the lucrative payouts. Parachute payments are compensation, including severance payments, (accelerated) equity compensation and any types of benefits, that are paid to disqualified individuals in connection with a change in control of the corporation (i.e., change in the ownership of effective control or of a substantial portion of the assets of the corporation). Disqualified individuals include shareholders, corporate officers and directors and highly compensated individuals who perform services for the corporation.[14]

Section 280G is triggered if parachute payments exceed three times the annualized includible compensation for a base period, or base amount. Then, not only will the corporation lose its tax deduction on the excess amount, but the disqualified individual will also owe a nondeductible 20 percent excise tax on the "excess parachute payment." Annualized includible compensation per section 280G is the average annual compensation (as reported on Form W-2) paid by the corporation to the employee over the most recent 5-year period. The excess parachute payment is the amount by which total parachute payments exceed the base amount. Simply put, once section 280G is triggered, any amount of an executive's parachute payments in excess of his or her base amount is generally subject to a nondeductible 20% excise tax.

Obviously, triggering section 280G provisions can be very expensive for both the corporation and its executives. From a planning perspective, companies may include gross up provisions in their severance agreements, or they may adopt such provisions in anticipation of a transaction. However, gross up provisions can be expensive and result in additional non-deductible expenses, as it essentially requires corporations to gross up parachute payments to neutralize the tax impact to the executive. Also, there are rules that provide shareholders with an advisory vote on the matter which, of course, will invite public and shareholder scrutiny. Other planning considerations include base amount planning to effectively increase the base amount by exercising stock options or accelerating stock awards during the base period. In these scenarios, executives should be cautioned to not unwittingly trigger the 20 percent excise tax under section 409A instead.

---

[14] IRC §280G(c)

https://scholarworks.sjsu.edu/sjsumstjournal/vol11/iss1/5
DOI: 10.31979/2381-3679.2022.110105

Key Takeaways

To recap, the following tables highlight (i) the key provisions and concepts of said tax statutes and provide (ii) a summary of the common types of equity-based compensation offered in executive compensation plans and their respective tax treatment:

IRC Section	Key Provisions
162(m)	Applies to corporations that issues publicly traded securities (debt or equity) • Deductibility of compensation is limited to $1 million per "covered employee" (all current or former principal executive or principal financial officers during the year and the three highest paid executives) • "Once a covered employee, always a covered employee" concept for tax years beginning after December 31, 2016 • Performance-based compensation included in $1 million limit since TCJA, unless grandfathered under old rule
409A	Applies to nonqualified deferred compensation plans. Provisions include documentation requirements (i.e., plan documents must specify amount to be paid, payment schedule, and triggering events) and irrevocable election regarding timing and form of payment made by the participant before the year in which the compensation is earned. • If 409A requirements met, tax deferral until payment or constructive receipt of the income • If 409A requirements not met, compensation includible in current year with additional 20% excise tax and potential penalties and interest payments – all imposed on the employee and not on the corporation • Short-term deferral exception for compensation paid within two and a half months after the end of the year • Equity-based compensation granted with an exercise price below FMV also subject to 409A • Independent appraisal of equity securities required to determine their FMV in certain situations
83(b)	Applies to property transferred to employees and service providers in connection with the performance of services • Special election to accelerate tax of full award in the year in which the award is made based on the FMV of the award at the time • Upon election, ordinary income tax and tax deduction triggered on award for executive and employer, respectively, and "start of clock" for long-term capital gain treatment
280G	Applies to parachute payments, i.e., compensation made to an executive in connection with a change in control of the corporation, in excess of three times the average annual compensation of a base period. • 20 percent nondeductible excise tax imposed on excess parachute payments in addition to applicable state and federal income taxes and employment taxes • Excess parachute payments nondeductible by employer

Award Type	Description	Tax Treatment
Incentive Stock Options ("ISO")	Provided under IRC sections 421 and 422. Subject to certain limitations: • Only available to employees	Employee: • No income upon grant or exercise of option if holding periods are met;

<table>
<tr><th>Award Type</th><th>Description</th><th>Tax Treatment</th></tr>
<tr><td></td><td>• Requires shareholder approval
• Limited to annually $100,000 in value of grant
• Exercise price must not be less than FMV of underlying stock (110% of FMV of underlying stock if granted to a 10% shareholder) on date of grant
• Plan and option are limited to a 10-year lifespan (5 years for >10% shareholders)</td><td>however, the difference between the FMV and the exercise price is treated as income for purposes of calculating the employee's alternative minimum tax
• Capital gain treatment on sale of stock if holding period requirements met (more than 1 year after exercise AND more than 2 years after grant)
• No employment taxes apply on the exercise of ISOs

Corporate employer:
• No deduction for ISOs</td></tr>
<tr><td>Nonqualified Stock Options ("NQSO")</td><td>• Any option that does not qualify as an ISO
• May be granted to any service provider (employee or nonemployee)
• Exercise price must not be less than FMV of underlying stock on date of grant (otherwise subject to section 409A penalties)
• More flexibility regarding lifespan of option (although companies typically apply 10-year lifespan)</td><td>Employee or Service Provider:
• Income and employment taxes apply on option exercise for amount equal to excess of FMV of stock (on date of exercise) over exercise price
• Capital gain on sale of stock if sale price is greater than FMV of stock on date of exercise

Corporate employer:
• Tax deduction equal to amount of ordinary income recognized by employee or service provider</td></tr>
<tr><td>Restricted Stock</td><td>• Right to full ownership of stock vests over time</td><td>Employee or Service Provider:
• Section 83(b) election available
• Income and employment taxes apply at the time of grant (if section 83(b) election is made) or vesting based on the then FMV of the stock

Corporate employer:
• Tax deduction equal to amount of ordinary income recognized by employee or service provider (depending on whether 83(b) election is made)</td></tr>
<tr><td>Restricted Stock Units</td><td>• Promise to pay stock or cash in the future upon vesting</td><td rowspan="3">• No tax until settlement
• Amounts received treated as ordinary income to the service provider and deductible by the employer
• Not considered property for purposes of section 83(b), so no election may be made under section 83(b) at the time of grant</td></tr>
<tr><td>Stock Appreciation Rights</td><td>• Right to receive the increased value of the employer's stock (service provider can only benefit from the appreciation in the value of the stock)</td></tr>
<tr><td>Phantom Stock</td><td>• Deferred amounts are determined by reference to hypothetical "phantom" shares of the employer's stock</td></tr>
</table>

No doubt, executive compensation is a complex topic. With compensation in the millions and even billions of dollars, as in the case of Elon Musk, the tax effects can be substantial. The

https://scholarworks.sjsu.edu/sjsumstjournal/vol11/iss1/5
DOI: 10.31979/2381-3679.2022.110105

difference between ordinary income taxed at 37 percent (highest marginal tax bracket in 2021) and capital gains taxed at 20 percent is impactful to the bottom line. Musk's move to increase his tax liability will not appeal to most of us, although there may be other not readily apparent factors that are influencing his stock sale decisions. This summary of key concepts and tax code provisions affecting executive compensation is not intended to constitute professional or legal advice. The tax rules and regulations governing executive compensation are nuanced and ever evolving, and there are obviously many exceptions and special rules that have not been covered here. As always, in determining the right course of action, companies and their executives will be best served by consulting professional tax and legal advice.