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Deferred Compensation Legislation Would Unduly Burden Equity-Based Awards

- Employers grant different kinds of equity-based compensation. In addition to stock options and restricted stock, an employer may prefer to grant bonuses to employees that are stated in the form of shares or units rather than dollar amounts. Often, such an award is called a “deferred stock unit,” which is simply the contractual promise to issue stock in the future after the employee has satisfied a vesting or other services requirement.
- The legislation would prohibit an “exchange” of a stock option for future payments, but it is **not** limited to stock options. The legislation would prohibit deferral of “*any compensation based on employer securities...for a right to receive future payments.*”
- With respect to stock options, it is unclear how this legislation would work. Employees do not “exchange” an option for future cash payments. Typically, an employee would elect in advance that when the option is exercised the employee would receive the employer’s promise to pay stock in the future rather than currently. Thus, it is unclear what is meant by an “exchange” of an option for deferred compensation. Sometimes, the terms of the option itself will state that upon exercise the employee will receive the right to receive stock compensation in the future. Until the date of issuance, the employee has a deferred compensation account that is expressed in shares rather than dollars.
- With respect to deferred stock units and other types of equity awards, the legislation appears to impose a complete ban on deferred compensation. This is an odd result because if the award were stated in the form of a dollar amount rather than shares, then employees could defer receipt of compensation under the award subject to the applicable timing rules.
- This distinction between cash and equity-based compensation makes no sense. There is no policy reason to prohibit deferral of equity-based awards or subject equity awards to stricter rules than apply to cash compensation.
- Code section 83 was enacted in large part to ensure that compensation paid in the form of property is subject to the same timing and inclusion rules as

compensation paid in cash. The legislation runs counter to this longstanding tax policy.

- The legislation would create an additional burden on equity-based compensation that is not merited. Deferring an award based upon employer securities ties up that award for a longer period of time and puts the employee at risk with respect to share price.
- Even if one accepts as true some of the recent criticisms of stock option compensation – *e.g.*, that stock options focus management unduly on short-term gains in stock price – that criticism is irrelevant here because deferring an equity award aligns the employee’s interest with longer-term investors. Moreover, this legislation applies to all equity-based awards and not just stock options.
- In sum, the legislation would create harsher rules for equity-based compensation than cash compensation. There is no tax policy reason to create this disparity.

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