



**Nonqualified Deferred Compensation Legislation  
Would Unnecessarily Restrict Stock Appreciation Rights (“SARs”)**

**Background**

- SARs are contractual rights that entitle the holder to a payment in either shares or cash equal to the appreciation in the employer's stock from the date of grant to the date of exercise of the SAR.
- For example, if a SAR that is exercisable in 5 years is granted when the value of the stock is \$100 and 5 years later the stock is worth \$150, the SAR would be worth \$50 at exercise. Depending upon the terms of the SAR, the \$50 may be paid in cash or in stock.
- SARs are economically equivalent to a fair market value stock option. Using the same example as above, if an employee had an option granted when the value of the stock is \$100 and exercised that option 5 years later when the value is \$150, the net to the employee would be \$50 because the employee would have to pay a \$100 exercise price. Under a typical employee stock option arrangement, the employee would utilize the current-law rules that allow “cashless” exercises and receive \$50 in stock at the end of the transaction. This is the same result as under a stock-settled SAR. Or, if the employee immediately sold the \$50 in stock that he received upon exercise of the option, this would be same result as the cash-settled SAR.
- SARs are widely utilized by privately held companies. Private companies award SARs that are settled in cash to replicate the financial incentives provided by stock options in public companies. A private company typically cannot transfer stock to its employees without violating securities laws.
- Many public companies are now utilizing SARs settled in shares in lieu of stock options. The proposed changes in the financial accounting rules for stock options would equalize the accounting treatment of options and SARs. Many companies now view SARs as more attractive than stock options because they result in less dilution to shareholders – even when settled in shares -- and do not require employees to pay an exercise price.

**Effect of Proposed Legislation on SARs**

- The Treasury and committee staffs all have indicated that the proposed NQDC legislation would not apply to stock options issued with an exercise price not less than the fair market value of the stock on the date of grant. According to the Treasury staff, however, the proposed legislation as currently drafted does not give Treasury authority to exclude SARs that are structured to be economically equivalent to such an option. The only rationale given for this different treatment seems to be based upon historical distinctions regarding the section of the Internal Revenue Code under which the compensation is taxed, although no one disagrees that fair market value SARs and options are economically equivalent.
- If the NQDC legislation applies to SARs, they will have to be radically altered. Under the NQDC legislation, employees would have to elect prior to receiving a SAR the exact date that the SAR would be exercised or the SAR by its terms would have to be automatically exercised on a date certain. That simply makes no sense. The value of SARs in the future are highly uncertain. SARs have value only if there is appreciation in the stock. A SAR that is automatically exercised when there has been no appreciation in the stock has no value and is useless as a compensation tool or an equity incentive.

### **Change to Legislation Needed**

- The NQDC legislation should be amended to specifically carve out both fair market value options and SARs.
- Under current law, SARs receive the same tax treatment as nonqualified stock options. An employee is subject to ordinary income tax (and the employer gets a tax deduction) on the amount of the spread at the time of exercise. SARs do not involve any “mismatch” or other tax abuse.
- An exception for fair market value SARs will not be a “loophole” in the legislation. SARs provide benefits only to the extent of the appreciation in the stock. They are not vehicles for deferring bonuses or other cash compensation.
- In part because of the current debate regarding the appropriate financial accounting treatment of stock options, many companies are evaluating the best approach to providing equity-based compensation. It is not sound policy for Congress to tip the scales in favor of one form of equity-based compensation over others based on historical distinctions regarding the section of the Internal Revenue Code under which the compensation is taxed.
- Many private companies rely on SARs to replicate the financial incentives provided by stock options. Private companies often use cash-settled SARs instead of stock options for many reasons including avoiding dilution of company ownership, a lack of liquidity in the company’s stock, and the securities law barriers (e.g., registration requirements and limitations on shareholders).