Skadden

Executive Compensation and Benefits Alert

November 26, 2012

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Strategies for Accelerating Income Into 2012

Tax rates for highly compensated individuals will increase in 2013, perhaps substantially. This is due in part to:

- Possible expiration in 2013 of the Bush tax cuts, resulting in increases in the highest marginal tax brackets;
- An increase in the employee share of the Hospital Insurance portion of FICA from 1.45 percent to 2.35 percent on all wages in excess of $200,000 for single individuals or $250,000 for married individuals filing jointly;
- Expiration of the 2 percent payroll tax holiday; and
- Possible increases in the tax rates applicable to capital gains and dividend income.

As a result, many employers and executives may wish to accelerate income into 2012 to reduce 2013 tax liabilities. However, the ability to accelerate compensation is severely limited by Section 409A of the Internal Revenue Code, which regulates the ability of employers and employees to change the time of payment of most types of compensation. Accelerating an award in violation of Section 409A will subject the employee to significant tax penalties.

Payments Not Subject to Section 409A May Be Paid in 2012

Bonuses

Most annual bonuses are not subject to the restrictions on acceleration of income under Section 409A. Accordingly, an employer generally may pay some or all of an employee's annual bonus at the end of 2012, instead of in the first months of 2013 (the time at which annual bonuses are normally paid), without violating Section 409A. However, if annual bonuses are intended to qualify as performance-based compensation under Section 162(m) of the Internal Revenue Code, the bonuses may only be accelerated if the compensation committee of the board of directors certifies the achievement of the 2012 performance goals prior to year-end. Alternatively, if the 2012 performance goals have not been fully achieved, early payment may be made based on the compensation committee's certification of performance goals that already have been achieved, and an additional payment may be made in early 2013, to the extent actual performance is higher. Because Section 162(m) rules are highly technical, a careful analysis will need to be performed to determine whether and to what extent a compensation committee may take action to certify performance results prior to year end.

Restricted Stock

Awards of restricted stock are not subject to Section 409A. Unless a Section 83(b) election was made, restricted stock is included in income upon vesting and, consequently, the employer may take action to vest restricted stock awards in 2012, causing 2012 income inclusion without violating Section 409A.

Stock Options and Stock Appreciation Rights

Stock options and stock appreciation rights generally are not subject to Section 409A. Thus, the employer generally may take action to accelerate the vesting of unvested stock options to 2012 so that the employee is able to exercise the options, and recognize income, in 2012. While this alternative may adversely impact the compensation objectives of the employer for awards that are not scheduled to vest until far into the future, it may be attractive for awards scheduled to vest in early 2013. An employee also may choose to exercise already-vested stock options in 2012, particularly if the options are scheduled to expire in the near future.

Restricted Stock Units and Other Phantom Equity Awards — Special Issues

Some restricted stock units and other phantom equity awards are not subject to Section 409A and may be paid in 2012 without violating Section 409A. This is the case for restricted stock units and other awards that provide for payment immediately following vesting. However, these types of awards must be carefully reviewed. Often, although initially appearing to be excluded from Section 409A, upon closer inspection these awards are found to be subject to Section 409A. As noted above, accelerating payment of an award that is subject to Section 409A will subject the employee to significant tax penalties.

Payments Subject to Section 409A: Acceleration of Payment Into 2012 Is Highly Restricted

Compensation subject to Section 409A and scheduled to be paid after 2012 generally may not be accelerated into 2012. However, a limited opportunity may be available to accelerate income into 2012 for payments that are otherwise scheduled to be paid in January 2013. Additionally, employers that are undergoing change in control events may be able to terminate plans and accelerate payment of all benefits previously accrued under the plan.

Other Planning Opportunities

High net-worth individuals also may take other actions not directly related to compensation payments that may be helpful in tax planning. These approaches may include:

- Accelerating capital gain transactions into 2012 rather than selling in 2013;
- Postponing tax-deductible expenditures to 2013 when such deductions may offset higher-bracket income (although certain deductions may be limited or decreased in 2013 in a manner that may eliminate the utility of this approach); and
- Converting individual retirement accounts (IRAs) to Roth status in 2012, thus taxing these funds at current lower rates and achieving nontaxable future growth.

Conclusion

Section 409A and, where applicable, Section 162(m), present significant barriers to the ability to accelerate compensation into 2012. Employers should carefully analyze their compensation arrangements with their legal and tax advisors to determine which compensation may be paid in 2012 without tax penalty.