

VIA ELECTRONIC MAIL [rule-comments@sec.gov]

August 22, 2015

Mr. Brent J. Fields  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street NE  
Washington, D.C. 20549-1090

Subject: **File Number S7-12-15**

Dear Mr. Fields:

The Securities and Exchange Commission (SEC) has proposed to add Section 10D to the Securities Exchange Act of 1934, requiring also national securities exchanges and national securities associations to prohibit the listing of any security of an issuing company that is not in compliance with its provisions. Section 10D implements also the provisions of Section 954 of Dodd-Frank (“DF”, *the Wall Street Reform and Consumer Protection Act of 2010*). Where there has been an accounting restatement, a publicly-traded company (PTC) must disclose their policy on their recovery of incentive-based compensation (IBC) received by certain executive officers that exceeds what would have been received under such restatement.

**Executive Compensation ‘Clawback’ *Denouement* – A Final *Piece* to the *Puzzle*.**

The SEC and the DF proposed rules have redefined the *practice* and possibly also the *status* of executive compensation. The issue at hand is the final leg in the four-legged stool of *major* issues implemented with the DF regulations, the first three being:

1. Anti-hedging Policies
2. Pay-for-Performance, and
3. Pay-Ratio between Named Executive Officer(s) and Median Employee Pay

The concept of *clawbacks* is not a new one but its usage as proposed could be particularly momentous to the practice of executive compensation for PTCs and to

the individuals that receive such compensation. Our prior commentary<sup>1</sup> discusses a heretofore unconsidered issue revolving around valuation issues attendant to equity governance practices at PTCs, particularly in light of *Robinson v. U.S.*[2003].<sup>2</sup> In addition, we have provided a detailed discussion and examples of the current tax, regulatory and investment planning treatment of stock-based compensation for key executives at our offerings on the Social Science Research Network (“SSRN”, author # shown below). **Our intent is to provide consideration of issues that have escaped public scrutiny to date.**

## DISCUSSION

### *The Practice of Executive Compensation - The Conundrum of Internal Revenue Code Section 83 (IRC§83)*

The practice of executive compensation, certainly as it relates to the equity IBC provided to corporate insiders and other key executive personnel, is multidisciplinary. Much of the tax treatment for equity compensation is governed by IRC§83, *Property Transferred for the Performance of Services*.

The comments to follow focus exclusively on the use of employer common stock and employee stock options (ESOs) as granted to named executive officers (NEOs) and other key executives of PTCs. These items of incentive compensation generally are taxed pursuant to IRC§83 and its regulations, where the issue of their status as *property* is considered. The simple rule to remember from a compensation plan standpoint is that the recipient of such compensation usually is taxed upon its receipt, where that receipt is accompanied by the *full* and *unfettered* use of same.

The ‘*Conundrum*’ that we speak of above is introduced by the SEC in their reliance on national exchanges in the penalty phase of their clawback provision, i.e., delisting of the shares of PTCs. The common stock of PTCs is traded actively on national securities’ exchanges and enjoys a freely traded value on what is known as a *minority-interest* basis, from a valuation standpoint. We refer to that value as a *fair market value* (FMV). The obvious comparison, by example, is such stock that is freely-traded and stock in the same company that has some form of restriction

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<sup>1</sup>See <http://www.sec.gov/comments/s7-01-15/s70115-1.pdf>

<sup>2</sup> *James G. Robinson, et ux. v. Commissioner*, 335 F.3d 1365 (Fed. Cir. 2003), No. 01-102T, Tax Analysts Doc. No. 2002-15273, 2002 TNT 126-10

present on its resale and is therefore considered to be *restricted stock*. As “delisting” is the ultimate marketability loss for a PTC, its anticipation could legitimately cause a reduction in value, and *taxability*, to the equity IBC as that equity is property to the holder.

The question of equity *value* has now become a *double-edged* sword for the executive recipient with the clawback issue. What we have discussed immediately above is one *edge* but the other *edge* is equally problematic. This comment also addresses the proposed rule’s position that the practice of clawing back compensation be done on a *pre-tax basis*, without consideration of the tax effects visited upon affected key executives upon the grant and vesting of PTC equity compensation and also exercise where such equity is in the form of ESOs.

If there is a clawback the practical issue for the effected executive, from a tax standpoint, is *when* the *clawbacked* income becomes a component of taxable income (TI) on their tax return(s). If all events take place within the same taxable year, then there is no problem.<sup>3</sup> There are considerable compliance and administrative issues for the executive taxpayer should income be reported on individual tax forms in one year with clawbacks occurring in a subsequent tax year.

The above highlights a *mismatch* in tax treatment between the original income, taxed fully and completely upon its receipt, and its status as a *miscellaneous itemized deduction* when it is “backed out” of taxable income (TI) in the clawback years, where its *full* deductibility becomes a function of its excess over an amount equal to 2% of the excess over the taxpayer’s adjusted gross income (AGI) for the taxable year.<sup>4</sup> This is where *Robinson* and a predecessor IRC§83-related issue are of some import in helping to clarify and expound upon these issues.

Certain taxpayers receiving stock-based compensation have at their disposal an artifice referred to as an IRC§83(b) *election*. The “election” requires a taxpayer to include in income in the year of such election the value of property [stock] received in a compensatory transfer in excess of that which was paid for same. That excess, or *bargain element*<sup>5</sup>, is usually taken in as income to the taxpayer with a similar amount claimed as a compensatory deduction by the employer. That is until *Robinson*.

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3 Rev. Rul. 79-311 1979-2 C.B. 25

4 Id

In *Robinson*, employer and employee were at odds with one another financially via the tax code. The employee claimed that there was no excess to be included in income on his tax return while the employer retroactively claimed that there was approximately \$25 million of excess entitling them to considerable tax deductions, revising their employee's Form W-2, income, and tax liability, for the years at issue.

IRS Announcement 2002-108 states that:

*“When an employee (or former employee) exercises nonstatutory stock options, employers are required to report the excess of the fair market value of the stock received upon exercise of the option over the amount paid for that stock. That amount is reported on Form W-2 in boxes 1, 3 (up to the Social Security wage base), and 5.”*

At issue was the accurate interpretation of IRC§83(h) that allows a compensatory deduction pursuant to IRC§162 in connection with the transfer of property for the performance of services, where the accompanying employer deduction is equal to the amount “included” in the employee's income, and more specifically Treas. Reg. §1.83-6(a)(2) stipulates that any amount included by the employee is deemed to have reported the compensation amount as includible in income when an employer reports such compensation to the employee.

However, the Federal Circuit (FC) saw everything in a different light ruling that “included” means included as a matter of law and therefore not dependent upon what an employee does or does not include on their return. Specifically, the FC stated,

*“We therefore reject the contrary interpretation set forth in the present version of Treasury Regulation §1.83-6(a).”*<sup>6</sup>

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<sup>5</sup> A *bargain purchase* is the purchase of an asset for less than its fair market value. In this context, a *bargain element* represents the difference between an ESO exercise price and the then fair market value of the underlying common stock times the number of shares being exercised.

<sup>6</sup> *Robinson v. U.S.* [2003]

One of the reasons for the *pre-tax* status of the clawback is that the SEC did not want to involve the employer in a dispute involving the employee executive's tax return, which apparently has also been lost on the SEC as *Robinson* has been in effect since 2003. A clawback necessarily involves the interplay between employer and employee tax compliance. A clawback then skews the possible value of equity compensation upon its receipt by the executive and then also with its possible recovery under the clawback provisions.

This presents an untenable potential whipsaw position for the IRS in such situations where an employer's compensation deduction is unmatched [from a tax revenue standpoint] by the income reported by the employee. *Robinson* also stipulated that,

*"The employer, however, has no standing to participate in a dispute between the employee and the IRS regarding the amount claimed by the employee as gross income..."*<sup>7</sup>

### ***The Status of Executive Compensation - The Directive***

In 1975, the Internal Revenue Service received the following direction from Congress, which we refer to as the *Directive*:

*"The Congress intends that in applying these rules for the future, the Services will make every reasonable effort to determine the fair market value for an option (i.e., in cases where similar property would be valued for estate tax purposes) where the employee irrevocably elects (by reporting the option as income on his tax return or in some other manner to be specified in regulations) to have the option valued at the time it is granted (particularly in the case of an option granted for a new business venture). The Congress intends that the Service will promulgate regulations and rulings setting forth as specifically as possible the criteria which will be weighed in valuing an option which the employee elects to value at the time it is granted."*<sup>8</sup>

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7 Id

8Tax Reform Act of 1976, General Explanation, p.154. See also S Rep No. 1236, 94<sup>th</sup> Cong. 2<sup>nd</sup> Session, 438-439.

A very important, salient point of the clawback issue as well as the entire discussion of the new DF regulations is the question of *when*, if at all, the equity compensation granted to key executive compensation actually becomes their property, i.e., when they have the full and unfettered use of same. The FC, in *Robinson*, has reminded us that, one of the important indicia of such property ownership remains with the taxpayer and that is the responsibility to include the value of such property in income in the filing of tax returns. The reason the Directive is so important to this discussion is in assessing the motives of the IRS as it relates to stock-based compensation.

Although the Internal Revenue Code (IRC) has an indirect method of identifying a *capital* asset, in most cases those assets also enjoy the status of *property*. So the purchase and sale of property often enjoys taxation at capital gain rates rather than at the much higher ordinary income rates of taxation. As a general rule of thumb, since the Directive's emergence in 1975, ordinary income rates of taxation have often been *twice* that of capital gains rates. With this in mind, we examine the IRS' treatment of certain components of stock-based compensation as property.

The IRC makes it extremely difficult for an ESO to be considered property and therefore subject to capital gain treatment which could be the normal outcome via the Directive.<sup>9</sup> IRC§83(a) talks about the transfer of property but Treas. Reg. §1.83-7 provides that IRC§83(a) only applies to an ESO if it has a readily ascertainable FMV (RAFMV) on the date of the grant of the ESO and that such status is only obtained if the ESO is traded on an established market, or failing that, if four conditions exist:<sup>10</sup>

1. The option is transferable by the optionee;
2. The option is exercisable immediately in full by the optionee;
3. The option is not subject to any restriction or condition which has a significant effect on the FMV of the option, and
4. The option FMV is readily ascertainable under Treas. Reg. §1.83-7(B) (3).

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<sup>9</sup> IRC§1234(a)(1); a *general rule* for options to purchase is that gain or loss shall be considered gain or loss from the sale or exchange of property which has the same character as the *property* to which the option relates in the hands of the taxpayer.

<sup>10</sup> Treas. Reg. §1.83-7(B) (2).

The IRS has positioned the tax treatment for ESOs to exact as much tax revenue over the years from this particular type of financial instrument as possible. In doing so, the capital gain *gauntlet* that they have established for the grant-based taxation of ESOs has served to provide taxpayers and other interested parties with a valuation proxy by the Service's own definition that resides in the listed, exchange-traded options (LETOs) that trade actively on a number of national securities' exchanges and that are close, if not identical cousins, in many ways to the ESO.

We have three important guiding lights for the discussion to follow; the first being the *Directive*, the second being *Robinson* and the third being the IRS' *indirect* endorsement of the LETO for the purpose of helping to resolve clawback implementation issues. We proceed from the belief that the original intent of Congress was that ESOs be taxed upon their grant and we are reminded by the FC in *Robinson* that individual taxpayers have the responsibility for the filing of their own tax returns in general, and even more specifically in establishing the value of property included on their returns that are the subject of stock-based compensation.

We also have been presented with the potential for a valuation proxy in that LETOs fulfill all the conditions established by the IRS in Treas. Reg. §1.83-7 to be considered property, *with the stipulation that, prospectively, the IRS or the Courts, or both have agreed to such usage.*

### ***The Status of Executive Compensation – Theophilos***

On January 9, 1996, the Appeal of *Theophilos* was decided by the U.S. 9<sup>th</sup> Circuit Court of Appeals.<sup>11</sup> The issue at hand was a dispute over the value of property, common stock, between an employer and an employee with the IRS waiting in the wings anxiously. The taxpayer employee argued that he purchased a 40% equity interest in his employer's common stock for the then fair market value (FMV) which also happened to be the purchase price of the stock, while the IRS and the employer argued that, at the time of purchase its value was substantially greater than that, i.e., about \$3.5MM greater, such amount benefitting the *employer* from a taxable compensation standpoint, i.e., deductibility, at the expense of the employee who then had added taxable income.

In the appeal, the 9<sup>th</sup> Circuit argued that the taxable event occurred in April of 1986 when the taxpayer entered into an *executory agreement* to purchase his employer's

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11*Theophilos v. Commissioner*, 85 F3d 440 (9<sup>th</sup> Cir. 1996), rev'g and rem'g 67 TCM (CCH) 2106 (1994).

common stock. In their decision, the 9<sup>th</sup> Circuit relied upon Treas. Reg. §1.83-3(e) and established the practical foundation of the Directive:

*“A contractual right to buy stock is not unsecured or unfunded if it is a binding obligation secured by valuable consideration. Thus, we hold that a contractual obligation to acquire stock, as well as an acquisition of stock, itself, is ‘property’ with the meaning of IRC §83, and if the contractual right to acquire stock is taxable under §83, the subsequent purchase is not.”*<sup>12</sup>

The issue in *Theophilos* was an employer’s obligation to deliver stock at some future time pursuant to an executory contractual employment agreement that may or may not be considered property under IRC §83, in conjunction with Treas. Reg. §1.83-3(e), where the emphasis was on a “binding obligation secured by valuable consideration.” The court ruled that an executive was not granted an option to buy stock i.e., not property, but rather an *executory contract* (EC) that included an obligation to buy stock. That contract was valued dependent upon the terms of the contract, which included the inability of the contract holder to ‘control’ the stock pursuant to the terms of the stock option plan and agreement.

We return to IRC§83(a) for some important connecting information. That code section stipulates that the FMV of property is...

*“...determined without regard to any restriction other than a restriction which by its terms will never lapse.”*<sup>13</sup>

This non-lapse restriction has become part of the fabric of the discussion over the years as to whether or not any form of stock-based compensation is entitled to some type of diminution in value due to the presence of certain restrictions. To further define this debate, accompanying Treasury Regulations have stipulated that a lapse restriction is one that is not a non-lapse restriction because it does not apply to subsequent holders of the property.<sup>14</sup>

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12 Id

13 IRC §83(a) (1).

14 Treas. Reg. §1.83-3(h) (ii).



What the Service has always maintained is that the presence of any restriction whatsoever is of no consequence in effecting FMV except for a restriction that basically is part of the security itself. The above point may have been overruled by the “delisting” standard of Section 10D which certainly does extend to subsequent owners of the property and must be considered now in an assessment of the value of stock-based compensation property subject to clawbacks.

### *Agency Theory (AT)*

There are a number of variants of AT that focus on the relationship of management to the shareholders of a PTC represented by the Boards of Directors. The long-standing belief that management and in particular key executives align their own best interests with the interests of the organization that they represent has now been supplanted somewhat. Certainly, on these various DF initiatives, key executive personnel have been placed at odds with their Boards. In our prior commentary to the SEC we suggested the implementation of a ***Corporate Insider-Trading Transaction Trustee*** or CITT whose duty it would be:

*“...to manage the tax, regulatory, investment and governance matters related to employer stock/option transactions for the corporate insider in a near-fiduciary capacity, without undue influence from any party, including the insiders themselves, save quarterly meetings during window periods.”<sup>15</sup>*

The legal relationship that top management has with their Boards is *contractual*, so the discussion introduced by *Theophilos* of an “executory contract” is not only fitting but may also be remedial. The CITT, as a fiduciary now also following trust law, would be responsible for also managing PTC equity transactions within a trust established for the benefit of the executive pursuant to an EC, the totality of which could be valued not only for individual income tax purposes but also for reasons related to clawbacks should they occur. The CITT’s responsibility would be to the executive and not the shareholder or the Board.

The answer then to the clawback implementation issue for all parties is to create an executory contract that includes both PTC common shares granted pursuant to an IBC plan along with the grant of ESOs also, against which LETOs are sold or written generating premium income within an employee trust into which these company securities are transferred. As both the company shares and the ESOs are

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<sup>15</sup> See <http://www.sec.gov/comments/s7-01-15/s70115-1.pdf>

subject to a substantial risk of forfeiture, i.e., clawback, and potential delisting, the value of the EC taken into income with the executive's IRC§83(b) election enjoys a reduced value for taxable income purposes with the approval of the IRS, or subsequently the Courts.

### ***Property Rights***

The Fifth Amendment to the U.S. Constitution says to the federal government that no one shall be "deprived of life, liberty or property without due process of law" [citation omitted]. The Fourteenth Amendment to the U.S. Constitution, ratified in 1868, uses the same eleven words, called the *Due Process Clause*<sup>16</sup>, to describe a legal obligation of all states. The broad professional community dealing with the above issues can ill afford the *intellectual indifference* that has beset the issue of property rights and executive compensation to continue.

### **Summary**

The SEC's clawback initiative in response to DF has indirectly reminded us of some very basic thoughts on the way we do things in the United States of America, and more specifically as it relates to the practice and status of executive compensation. They are:

1. In a compensatory context, what exactly constitutes property and should ESOs be considered as such within an executory contract as discussed above, and
2. Are the rights of an executive in such property abridged somehow, *without due process*, by the restrictions discussed above, with the ultimate restriction being the penalty represented by Section 10D, i.e., delisting.

Americans believe in *fair play*. Clawbacks may very well play an important role in the future of corporate governance, executive compensation and financial reporting, but not without due consideration of the changes that they may create. The idea of a CITT and an EC are two *prospective* ideas that may help *level the playing field*.

We appreciate the opportunity to provide insight on this very important issue.

Best Regards,

Timothy R. Wing, MST

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<sup>16</sup> See [http://www.law.cornell.edu/wex/due\\_process](http://www.law.cornell.edu/wex/due_process).

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