

# ARTHUR ANDERSEN

To: Files

From: Rod L. Anderson  
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Date: May 22, 1998

Subject: Western Resources, Inc./  
Split Dollar Arrangement/  
Key Tax Considerations

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## FACTS:

During 1997, the earnings of Western Resources, Inc. (Western Resources or the Company) increased significantly. The results were due primarily to the efforts of six key executives. Western Resources desires to reward these executives for their valuable services. However, the existing executive incentive programs did not contemplate the significant earnings achieved and do not adequately compensate them for the value delivered to the Company and its shareholders. Therefore, Western Resources is proposing to provide these executives with additional compensation and benefits.

The proposed program will consist primarily of a split dollar life insurance arrangement. It will also be structured to provide the executives with the ability to receive cash compensation through a "put" option. The "puts" will include features that may cause their values to vary based upon the future stock price of Western Resources.

## ISSUE:

What are the tax consequences of the put option for the Company and the executive? Is it treated as compensation as of the date of grant, the date it becomes exercisable or upon actual exercise?

## CONCLUSION:

This is a unique arrangement for which there is no precedent. However, there is a reasonable basis under Internal Revenue Code (IRC) Section 451 for the position that the put option is not taxable until the exercise of the option. Therefore, the executives should not recognize taxable income until they receive cash as a result of exercising the put. We believe this is a reasonable position based upon the IRC of 1956, the regulations thereunder, reported judicial decisions, and the current positions of the Internal Revenue Service (Service) as reflected in published and private rulings as of the date of this memo.

The Company would be entitled to a deduction for the put as compensation to the executive; however, the deduction would be delayed until the put becomes taxable to the executive. The Company's deduction may be limited by the \$1 million cap on executive compensation provided by IRC Section 162(m).

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**APPLICABLE LAW:**

The put option potentially represents cash compensation from the Company to the executive. Such compensation would be taxable to the executive under IRC Section 61 and deductible by the Company under IRC Section 162. However, the executive's taxation may be delayed under IRC Section 451, and the Company's deduction would be delayed accordingly.

IRC Section 451(a) is the general timing rule for inclusion of items in gross income. It states that items are included in gross income in the taxable year received, unless it is properly accounted for in a different period.

Regulations Section 1.451-2(a) clarifies the constructive receipt rules:

Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

The Internal Revenue Code and regulations do not define "substantial limitations or restrictions." However, the issue of whether "substantial limitations or restrictions" exist is discussed in rulings. In general, if a taxpayer is required to forfeit some other valuable right, then the forfeiture is considered to be a substantial limitation that would cause taxation of a benefit to be delayed.

In Rev. Rul. 80-300, the Service considered the taxability of a stock appreciation right (SAR) with respect to the corporation's common stock. A company granted SAR's to executives, entitling them to a cash payment equal to the excess of the fair market value on the date of exercise over the fair market value on the date of grant. The issue was the timing of the taxation of the SAR's. The Service analyzed the issue as follows:

The courts and the Internal Revenue Service have recognized that a requirement of surrender or forfeiture of a valuable right is a sufficient restriction to make inapplicable the doctrine of constructive receipt. ...

The forfeiture of a valuable right is a substantial limitation that precludes constructive receipt of income. The employee's right to benefit from further appreciation of stock, in this case, without risking any capital is a valuable right. However, once the employee exercises the stock appreciation rights, the employee loses all chance of further appreciation with respect to that stock and the amount payable becomes fixed and available without limitation."

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In Rev. Rul. 82-121, the Service also considered the taxability of SAR's. In that situation, the executive was granted both SAR's and nonqualified stock options with respect to a certain number of shares. The exercise of either the SAR's or the stock options resulted in the cancellation of the other right with respect to such shares. The issue was the timing of the taxation of the SAR's. The Service analyzed the issue as follows:

In order to exercise the SAR's, A must surrender the related options and thereby forfeit the right to benefit from any appreciation of the optioned stock in excess of the price at which the related option could have been exercised. In this case, the loss of the stock option purchase rights is the loss of a valuable right, and therefore, is a substantial limitation that precludes the constructive receipt of the appreciation in the SAR when it first reached its maximum value (20x dollars) on May 1, 1981. Accordingly, A will not be in receipt of income until the options are exercised in 1982.

The IRS has also concluded that if there is a cap on the amount that the executive can receive, then the executive will be in constructive receipt of the benefit on the date such cap is reached.

There are numerous private letter rulings relating to SAR's that apply this analysis. Recent rulings include Private Letter Ruling 9435001 and 9413023.

The Service has also applied these principles to other compensation arrangements in Private Letter Rulings. For example:

- Phantom stock in Private Letter Rulings 8117078, 8949032, 9233005, 9413023;
- Both phantom stock and related dividend equivalents in Private Letter Rulings 8353079 and 8513047;
- Performance units, based on attainment of certain corporate measures, in Private Letter Rulings 8133029, 8147103 and 8829070;
- "Book Value Units" and similar arrangements, based on shareholder's equity or net worth divided by shares deemed outstanding, in Private Letter Rulings 8144049 and 8925054, respectively; and
- SAR's and related dividend equivalents in Private Letter Ruling 9037042.

The tax court has also applied the principles of Rev. Rul. 80-300 to phantom stock in Martin v. Commissioner, 96 TC 814 (1991).

## DISCUSSION AND ANALYSIS:

### *Western Resources Program*

Western Resources is proposing to provide additional compensation and benefits to executives as a result of the significant increase in its earnings during 1997. The Company reported income before taxes of \$572 million compared to \$251 million and \$266 million in 1996 and 1995, respectively. Earnings per common share were \$7.51 compared to \$2.41 and \$2.71 in 1996 and 1995, respectively. These increases created additional value for the shareholders.

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The results were due primarily to the efforts of six key executives: John E. Hayes, Jr.; Norm Jackson; David C. Wittig; Steven L. Kitchen; Carl Koupal; and John K. Rosenberg. Western Resources desires to reward these executives for their valuable services. However, its existing programs did not contemplate those levels of earnings and do not adequately compensate them for these valuable services.

Western Resources considers it desirable to utilize a form of benefit that may be tax effective for income tax purposes because this is extraordinary income to the executives. Therefore, the program will consist primarily of a split dollar life insurance arrangement.

However, the Company also recognizes that the program is primarily intended to compensate the executives for their past services during 1997, so it will also be structured to provide the executives with the ability to receive cash compensation after three years through a "put" option.

As additional incentives, the "puts" will include a feature that may cause their values to vary. The conversion ratio for the put will initially be \$1.00 of cash for every \$1.50 of death benefits. However, this conversion ratio will vary based on changes in the value of Western Resources stock. It is intended that this feature may provide incentives to some executives to continue in employment. The possibility of future increases in the value of the arrangement may deter the executives from exercising their puts, and the executives will be more likely to continue in employment if the exercise of the put options is delayed.

#### *Split Dollar Arrangement*

Western Resources will utilize an endorsement split dollar life insurance arrangement to provide the additional benefits to the executives.

The Company will purchase universal life insurance policies from Transamerica Occidental Life Insurance Company. It is currently intended that policies will be funded with a single premium, causing these policies to be modified endowment contracts for tax purposes. A modified endowment contract is subject to income taxation on any loan from the policy or any surrender of the policy, and is subject to an additional ten percent excise tax on such amounts.

Western Resources will own the policies. Western Resources will pay the premium(s) on the policies. Western Resources' interest in the policies will always be equal to at least the greater of the aggregate premiums paid or the cash value of the policies.

The executives will not be required to contribute any part of the premium or to currently reimburse Western Resources for the premium payment(s) it makes. There will be an endorsement of a portion of the death benefit equal to the excess over Western Resources' interest. The executives will be entitled to designate a beneficiary for their portion of the death benefit.

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The tax treatment of this arrangement will be consistent with split dollar reporting. In other words, an executive will be required to report an economic benefit equal to the term insurance value of the death benefit (e.g., the one-year term cost determined using PS 58 table rates or the current published premium rates charged by an insurer for individual one-year term life insurance). The executive would also be taxed on any "other benefits" provided under the split-dollar arrangement.

It should be noted that in a 1996 technical advice memorandum, the IRS concluded that an employee should also report annually as taxable income the net equity buildup in the life insurance contract. However, the case described in that ruling involved a collateral assignment equity split dollar arrangement under which the employee owned the policy and had access to the increases in cash surrender value. In this case, the Company owns the policies under endorsement split dollar arrangements and the executives do not have access to the cash surrender values.

#### Cash Put Option

As noted above, the program will also be structured to provide the executives with the ability to access some additional cash compensation. This will be accomplished by the Company granting the executives the right to "put" some or all of their death benefit to the Company for additional cash compensation.

The "put" will be exercisable by the executives at the earlier of three years or retirement.

The conversion ratio for the put will initially be \$1.00 of cash for every \$1.50 of death benefits. However, this conversion ratio will vary based on changes in the value of Western Resources stock as described in Section 5 of the Split-Dollar Insurance Agreement.

**Executive's Right to Sell Policy Interest to Corporation.** The Corporation hereby grants to the Executive beginning on the earlier of (i) three (3) years from the date of the policy, or (ii) the first day of the calendar year next following the date of Executive's retirement as defined in the Western Resources Inc. Executive Salary Continuation Plan dated July 17, 1996, the right from time-to-time and in whole or in part to offer to the Corporation and the Corporation shall purchase his interest in the death benefit under the policy at a discount equal to one dollar (\$1) for each one and a half dollars (\$1.50) of the then applicable death benefit of the policy with respect to which the Executive then has the right to designate or direct the beneficiaries and which Executive offers to the Corporation under this Section 5, as adjusted below; provided, however, the Executive's right to sell his interest in the policy shall be exercisable only upon the condition that Executive is a shareholder of the Corporation on the date of such sale. The parties hereto agree to take all action necessary to cause the beneficiary designation and any endorsement to reflect any such sale and purchase. The payment provided above in this Section 5 shall be adjusted in relation to the change in the average of the daily closing prices of Corporation common stock on the New York Stock Exchange for the twenty days ending the date of the offer by Executive from the average of such daily closing prices for the twenty days ending on the date hereof, such that, for each percentage change in such average, the dollar amount of the payment shall change in the same direction by one percent provided, that the amount of any...

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resulting increase in the payment to the Executive shall not exceed 10% per year, and the amount of any resulting decrease in the payment to the Executive shall not exceed 25% per year, and provided further, that in no event shall the payment exceed the face amount of the policy. The above limitations notwithstanding, the Executive may offer to the Corporation, and the Corporation shall purchase, on the basis described above, up to 5% in 1998, and up to 10% in each of 1999 and 2000, of the then applicable death benefit of the policy with respect to which the Executive then has the right to designate or direct the beneficiaries. The Executive's rights under this Section 8 shall terminate at the time of the death of the Executive to the extent it has not been exercised before that time.

*Analysis*

In the arrangement described herein, the executives must give up two valuable rights upon exercise of the put

- the right to future appreciation in the put due to increases in the put option up to the cap (e.g., the death benefit); and
- the right to the death benefit under the split dollar arrangement.

Although there is no precedent for the taxation of this arrangement, there is a reasonable basis for the position that under IRC Section 451 no taxation occurs until the exercise of the option. It is possible that the IRS could argue that the executive has constructive receipt on the date that the put right equals the cap (e.g., the date that it equals the full amount of the executive's death benefit); however, the executive would still be able to argue that the right to a tax free death benefit was a valuable right.

The Company would be entitled to a deduction for the put as compensation to the executive; however, the deduction would be delayed until the put becomes taxable to the executive. The Company's deduction may also be limited by IRC Section 162(m)'s \$1 million cap on executive compensation. Under Section 162(m) a publicly held company generally cannot deduct more than \$1 million with respect to the compensation of the chief executive officer and the other four officers whose compensation is required to be reported to shareholders in the proxy. There are exceptions to this requirement, but they are unlikely to apply in this situation.

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