EXECUTIVE COMPENSATION

A MILLION DOLLAR PROBLEM?

By Robin Struve*

As executives’ base compensation and bonuses have increased dramatically in recent years, more and more officers are approaching or exceeding compensation of $1 million. Section 162(m) of the Internal Revenue Code of 1986, as amended (Section 162(m)), generally limits to $1 million per year the deductibility of compensation paid by a publicly-held corporation to certain executive officers. However, certain performance-based compensation that meets specific IRS rules is not subject to this $1 million limit.

Most public company proxies have a statement indicating their intentions with respect to the general deductibility of compensation under Section 162(m). Although companies may design or intend to have their compensation plans pay deductible compensation under Section 162(m), they in fact may not be doing so. In recent years the IRS has increased its audit focus on Section 162(m) and has generally found a high level of noncompliance. In most instances, noncompliance is due to minor ministerial errors and insufficient internal procedures. Accordingly, publicly-held companies should review their procedures for determining the deductibility of compensation paid to executives to ensure compliance with Section 162(m) and, if necessary, either adjust those procedures or their proxy disclosure, as appropriate.

This article provides an overview of the Section 162(m) rules, focusing on particular areas where the IRS has found non-compliance. A checklist for reviewing whether or not compensation is deductible under Section 162(m) is provided at the end of this article.

SECTION 162(m) OVERVIEW

Does Section 162(m) apply to all companies? No, Section 162(m) only applies to corporations that issue securities required to be registered under Section 12 of the Securities Exchange Act of 1934. This generally

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includes most corporations that are traded on an exchange, such as the New York Stock Exchange or NASDAQ. However, corporations that voluntarily register and corporations with publicly traded debt are not subject to the limits of Section 162(m). Additionally, foreign issuers that have American Depository Shares or American Depository Receipts traded on an exchange generally will not be subject to Section 162(m).

Who is a Covered Employee? Only compensation paid to “covered employees” is subject to the limits of Section 162(m). Covered employees include the chief executive officer (CEO) and the three most highly compensated executive officers who are executive officers as of the last day of the company’s tax year. However, under current rules, a company’s chief financial officer (CFO) will not be a covered employee.

Until 2007, the CFO could be considered a covered officer under Section 162(m) if he or she was one of the four most highly compensated officers of the corporation and therefore included on the summary compensation table contained in the corporation’s annual proxy. However, when the Securities and Exchange Commission (SEC) revised the rules regarding disclosure of executive compensation (which for most companies first applied in the 2007 proxy season), it required the inclusion of the CFO in the summary compensation table regardless of his or her compensation. The IRS in response issued an interpretative notice that curiously exempted CFOs from being covered employees, even if they were one of the three most highly compensated officers.

Generally, the officers (other than the CFO) who are listed in the summary compensation table in the proxy are the covered employees for the year. However, not everyone listed in the summary compensation table is a covered employee. Only individuals who were executive officers as of the last day of the corporation’s taxable year will be covered employees for Section 162(m) purposes. Thus, any individual who was not an officer at year end, but who may otherwise be required to be included in the summary compensation table under the SEC’s proxy disclosure rules will not be a covered employee for Section 162(m) purposes.

What compensation is covered? For purposes of Section 162(m), “compensation” is defined broadly to effectively cover all taxable compensation received by a covered employee from the corporation. However, “qualified performance-based compensation” (QPBC) will be ex-

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empt from the million dollar deduction cap. Thus, all taxable compensation received by a covered executive, in whatever form, is taken into account in determining whether total compensation exceeds $1 million unless such compensation qualifies for the QPBC exemption or another applicable exemption.

When is compensation subject to the limitation? The deduction limitation applies in the employer’s tax year for which the compensation is paid or otherwise made available and includible in the employee’s income. Compensation which is deferred is not includible in the employee’s compensation at that time. Instead, it is subject to the deduction limits in later years when the compensation is paid and included in the employee’s income. This creates a planning opportunity. A covered employee can defer compensation that is not QPBC, which exceeds the Section 162(m) limit until years in which either they are no longer a covered employee or their non-QPBC compensation is less than $1 million.

To illustrate the general mechanics of Section 162(m), consider this example: a covered employee receives the following taxable income from the company in a year: (i) a $900,000 base salary; (ii) $600,000 in a discretionary non-performance based bonus; (iii) $300,000 upon the exercise of a nonqualified stock option that does not qualify for the QPBC exemption; (iv) a $2,000,000 performance-based bonus that qualifies for the QPBC exemption; and (v) $2,500,000 upon the exercise of a nonqualified stock option that qualifies for the QPBC exemption.

In this case, the amount taken into account for purposes of the Section 162(m) million dollar deduction cap would be $900,000 + $600,00 + $300,000 = $1,800,000. This means that for federal income tax purposes the company could deduct as a compensation expense only $1,000,000 of such $1,800,000. The remaining $800,000 would not be deductible because it exceeds the Section 162(m) million dollar deduction cap. However, because both the $2,000,000 bonus and $2,500,000 received upon the exercise of options qualify for the QPBC exemption, they are not taken into account in determining whether total compensation exceeds $1 million for purposes of Section 162(m). Additionally, such amounts would be fully deductible by the company.

What is performance-based compensation? QPBC is defined as remuneration payable solely on account of the attainment of one or more objective, pre-established performance goals if three requirements are met:

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3. The other types of compensation that are generally not subject to the Section 162(m) million dollar deduction cap are (i) commission payments; (ii) payments to or from a tax qualified retirement plan; (iii) certain fringe benefits; (iv) payments under a written binding contract that was in effect on February 17, 1993 (unless the contract is materially modified); and (v) payments under plans or agreements in effect prior to the date the corporation became publicly traded as more fully described below.
Committee of Outside Directors - the performance goals are determined by a committee or subcommittee of the corporation’s board of directors consisting solely of two or more “outside directors”; 

Stockholder Disclosure and Approval - the materials terms of the remuneration, including the performance goals, are disclosed to the corporation’s stockholders and approved by a majority of the vote of such stockholders before such compensation is paid; and 

Certification - the committee of outside directors certifies the attainment of the performance goals and satisfaction of other terms before such compensation is paid.

Who are Outside Directors? It is critical that only outside directors establish and approve performance-based compensation. Having individuals who were not “outside directors” establish and approve performance compensation was one of the common errors the IRS found during its audits.

To be an “outside director,” the director cannot receive, either directly or indirectly, compensation from the corporation other than director’s fees. In addition, such individual may not be:

- A current employee of the publicly-held corporation;
- A former employee who is still receiving any deferred compensation from the publicly-held corporation;
- A current or former officer of the publicly-held corporation (even if serving in an interim capacity);
- A fifty percent or more owner of an entity (includes sole proprietorships, partnerships and their related entities) that receives any remuneration from the corporation;
- An individual who owns between five and fifty percent of an entity that received during the preceding taxable year more than de minimis remuneration from the corporation. For this standard de minimis is considered to be the lesser of $60,000 or five percent of the recipient entity’s gross revenues;
- An individual who owns less than five percent of an entity which employs the individual if, during the preceding taxable year, the entity received more than de minimis remuneration from the public company. For this standard de minimis is considered to be less than five percent of the gross revenues of the recipient entity. However, if the services are “personal,” de minimis is less than $60,000. Services are personal if they are legal, accounting, investment banking or management consulting services.

Interestingly, directors who may be “independent” for NYSE or NASDAQ purposes or “non-employee” directors for purposes of Section 16 of the Securities Exchange Act of 1934, may still not qualify as “outside directors” for purposes of Section 162(m). Accordingly, corporations should review the composition of their compensation committees each
year to confirm that each of the directors meets the requirements of an “outside director” for Section 162(m) purposes.\textsuperscript{4} Such review should be done when the company is determining whether or not such directors are independent for exchange purposes or whether or not they are subject to any related party transactions which need to be disclosed in the company’s annual proxy.

Corporations should also review their compensation committee charters and their procedures to determine if the compensation committee is actually setting and approving the performance-based compensation for the covered employees as well as anyone else who potentially could be a covered employee at year-end. For example, it is fine for the compensation committee to approve the performance goals and compensation, with the full board ratifying such decision. However, it is not enough for the compensation committee only to recommend goals and compensation if it is the full board that actually approves such compensation, unless the full board consists solely of outside directors.

What makes a performance goal?

To qualify for the QPBC exemption, performance goals must be objective and pre-established.

\textit{Objective Criteria}

A performance goal will be objective if a third party, having knowledge of the relevant facts, could determine whether such goal is met and mathematically calculate the maximum amount payable. Business criteria that may be used to set objective performance goals include: pre-tax income, operating income, cash flow, earnings per share, return on equity, return on invested capital or assets, cost reductions or savings, funds from operations, appreciation in the fair market value of the company’s common stock and earnings before any one or more of the following items — interest, taxes, depreciation or amortization.

\textit{Pre-Established Performance Goals}

Next, performance goals must be established before the performance period begins. A performance goal will be considered pre-established if the compensation committee establishes such goal in writing at

\textsuperscript{4} If not all members of the compensation committee qualify as “outside directors,” it is possible to create a Section 162(m) subcommittee comprised solely of outside directors to approve performance compensation, if permitted by the compensation committee charter. (See I.R.S. Priv. Ltr. Rul. 98-11-029 (Dec. 9, 1997) where compensation committee included individuals who were not outside directors who abstained from voting and recused themselves from discussion on QPBC). However, if such a subcommittee is used, proper procedures must be put in place to avoid inadvertent violations of the Section 162(m) requirements. Generally, it is preferable that all members of the compensation committee qualify as outside directors. Accordingly, for purposes of this article, we will discuss approvals being made by the compensation committee.
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any time not later than ninety days after the beginning of a performance period (or, if sooner, the date on which twenty-five percent performance period has elapsed), provided that the outcome is substantially uncertain at the time the performance goal is established.

In its audit review, one of the areas the IRS noted as frequently being non-compliant was the adjustment of pre-established performance goals. As a general rule, performance goals should not be changed once in place. However, a pre-established performance goal may be adjusted due to unforeseen business circumstances, such as acquisitions, dispositions, stock splits, and non-recurring accounting charges. Such changes are allowed only if they are permitted by the plan, as approved by stockholders, and they are objectively determinable adjustments established at the time the original goal is set. Otherwise, changing performance targets during the performance period, but after the deadline for having “pre-established” goals, would void the QPBC status for such bonuses.

Negative Discretion

As noted above, compensation payable based upon subjective criteria generally will not satisfy the QPBC requirements. However, the compensation committee has some opportunity for flexibility because it may retain so-called “negative discretion” to reduce the amount of the compensation payable upon the attainment of the performance goals. Negative discretion allows an element of subjectivity in bonus determinations. Under a “negative discretion” plan generally, the executive will be eligible for a maximum bonus once a pre-established level of performance (usually the threshold level) is achieved. The compensation committee can then use its discretion to lower the bonus amount based on such factors as it deems appropriate, including subjective factors. However, this only works one way. Discretion cannot increase bonuses without losing QPBC treatment.

What is required for stockholder approval? The company’s stockholders must approve the material terms of any performance goals, including the employees eligible for compensation, a general description of the business criteria upon which performance goals are based (but not necessarily the exact formula) and, if the exact formula is not given, the maximum amount of compensation payable to an employee prior to the time the bonus is paid. Every five years, stockholders must reapprove the performance goals with respect to which QPBC is paid. Although this re-

5. In general, whether compensation satisfies the QPBC exemption is made on a grant by grant basis. Thus, for example, a covered employee may receive multiple bonuses from the Company, one or more of which qualifies for the QPBC exemption and the others of which do not. Therefore, if the Company wishes to provide a covered employee with a bonus that is partly based on objective factors and partly based on subjective factors, the Company could do so by providing two separate bonuses, one of which is structured to comply the QPBC exemption and the other of which is not.
requirement does not apply to stock options and stock appreciation rights (SARs), because some public companies have adopted omnibus equity plans which permit grants of other forms of equity awards, such as restricted stock, restricted stock units, deferred stock, phantom stock or may include a cash-based bonus award, unless such a plan’s performance goals are reapproved every five years, the other equity grants will not qualify as QPBC.

Failure to obtain stockholder approval or reapproval of a plan and changing performance criteria without obtaining stockholder approval are two areas that the IRS noted as being particularly problematic in its audits for Section 162(m) compliance. Accordingly, companies should review each year whether or not they need to submit any compensation plans to stockholders for approval, if they are changing performance criteria or for reapproval as appropriate.

**When must certification occur and how is it accomplished?** Before any QPBC payment is made, the compensation committee must certify that the applicable performance goals have been satisfied. Although this is a technicality, this is an area where companies do mess up. Even if it is known that the goals were met, compensation should not be paid until the committee certifies the results for Section 162(m) purposes. The results can be certified by the compensation committee at a meeting which certification is then reflected in the minutes of the meeting.

Certification of the goals being met and documentation of such certification is particularly important with respect to equity awards that may vest or otherwise become payable based on performance. The award agreement should specify that the vesting or payment date is the date that the committee certifies that the goal is met, not the date the goal is met.

**Is there anything else I should know?**

*Review Plans and Agreements for Payments upon Termination and Retirement*

In January 2008, the IRS reversed a long-standing position regarding the payment of QPBC in the event of retirement or termination of employment. Under the new IRS position, compensation is not QPBC if a covered executive has a right—even one that is never triggered—upon a termination of employment or retirement to be paid all or a portion of compensation intended to be QPBC without regard to actual satisfaction of the QPBC targets. However, compensation payable upon death, disability or change in control regardless may still meet the requirements of QPBC.

This is best demonstrated with an example.

Assume a company has an annual bonus plan that pays bonuses based on EBITDA. The plan was approved by stockholders in the last five years.
years. A compensation committee of outside directors approves an EBITDA goal within the first ninety days of the company’s fiscal year. The compensation committee certifies that the EBITDA goal was met prior to payment. Therefore, bonuses under this plan would be expected to meet the QPBC requirements and avoid the limitations of Section 162(m).

However, the CEO’s employment agreement provides for severance in the event that he is terminated without cause or he terminates for various enumerated “good reasons.” Under such agreement, his severance includes a bonus at target for the year of termination regardless of actual performance.

The existence of this provision in his employment agreement will cause the CEO’s bonus to fail to be QPBC. This is the case even if he is not terminated during the year because the employment agreement creates the possibility he could receive the bonus without following the normal QPBC requirements.

The IRS provided transition relief for its change in position for:

- plans in which the performance period for a performance goal begins on or before January 1, 2009; or
- compensation paid under an employment contract as in effect (without respect to future renewals or extensions, including any automatic renewals or extensions) on February 21, 2009.

In light of this change, it is critical that companies review their plans and agreements to determine whether any of them cause compensation that otherwise would be QPBC to not comply. Possible solutions include (i) paying the QPBC bonus only if and when it is paid to other employees at the end of the performance period (with or without proration); (ii) truncating the performance period and paying early, based on actual performance; or (iii) basing the severance on prior years’ bonus amounts.

**Equity Compensation**

Section 162(m) has special rules governing stock options and SARs. There are special rules governing how stock options and SARs can be QPBC. Compensation attributable to stock options or SARs will qualify as QPBC as long as:

- **Compensation Committee** - the grant is made by a committee composed solely two or more of outside directors;
- **Award Limit** - the plan under which the grant is made states the maximum number of shares that may be granted to any employee during a specified period of time (such as a calendar year);
- **Exercise Price** - under the terms of the option or SAR, the amount of compensation a covered employee can receive is based solely on the increase in the value of the stock after the date of the grant. (For example, with options, this means they must have an exercise price at least equal to fair market value on the date of grant); and
- **Stockholder Disclosure and Approval** - stockholders approve by separate vote the specific terms of the plan including the award
limit, a description of employees who are eligible under the plan, and any other material plan provisions.

Unlike other forms of QPBC, there is no requirement that the compensation committee certify the performance goals are met prior to the exercise of an option or SAR.

Other forms of equity compensation, such as restricted stock, restricted stock units, deferred stock, and phantom stock generally will not qualify as performance-based compensation unless the executive’s rights to vest in and receive such awards are based on pre-determined performance criteria that will otherwise meet the requirements of QPBC. For these types of equity awards, the compensation committee must certify that the performance goals are met.

Some companies’ practices regarding grants of stock options and SARs could jeopardize future Section 162(m) deductibility. In particular, some compensation committees approve a pool of options/SARs that are then allocated among employees by the CEO or another executive officer. This practice puts the future deductibility of those options and SARs at risk. For tax purposes, compensation is not received upon the grant of an option or SAR but only upon its later exercise. For example, an individual receiving a grant may not be an executive officer. However, he might be one when he exercises and, by reason of the exercise, become one of the top three most highly compensated employees and a covered employee for the year of exercise. Therefore, any company that wants to ensure compliance with Section 162(m) deductibility (and also practice good corporate governance) should have all option and SAR grants approved by the compensation committee.

Newly Public Companies

Compensation plans which are effective before a company becomes publicly-held are subject to special transition rules which permit delayed compliance with Section 162(m). For companies that become public through an IPO, these transition rules require the IPO prospectus to disclose information about the plan that complies with applicable securities laws. Compensation paid under plans that meet these disclosure requirements will not be subject to Section 162(m) until the earliest of:

- the expiration of the plan or agreement;
- the adoption of a material amendment to such plan;
- the issuance of all the stock or other compensation allocated to the plan; or
- the annual meeting in the fourth year following the IPO.

Subsidiaries which become publicly-held through a spin-off or other similar transaction are also subject to certain transition rules. Under these transition rules, compensation will be QPBC if:

- the parent company’s outside directors establish the performance-based compensation for the subsidiary before it becomes a separately publicly-held corporation;
• the material terms of the performance goal under which the compensation is to be paid are disclosed to, and subsequently approved by, the stockholders; and
• the subsidiary’s compensation committee certifies that the performance goals are met.

Additionally, there is an exception to the stockholder approval requirement for compensation paid and stock options, SARs and restricted stock granted prior to the first regularly scheduled meeting of stockholders of the new public company that occurs more the twelve months after the date the company becomes separately publicly held, as long as the performance goals are established and administered by either the outside directors of company before it becomes public, or of the newly public company.

Companies that have recently gone public, either through an IPO or otherwise, should make sure that they either are covered by these transition rules or compliant with Section 162(m).

CONCLUSION

Section 162(m) compliance is required only if a company wants to deduct compensation over $1 million paid to covered executives. For various reasons a company may decide that it will pay compensation which is not deductible. However, such decision should be intentional and not as a result of failure to comply with the ministerial requirements of Section 162(m).

Inadvertent failures to comply with any of the QPBC requirements of Section 162(m) may cause such compensation not to be deductible. The loss of such deductions not only may result in penalties imposed by the IRS, but could also expose the company to a myriad of other potential problems, including those relating to restatement of financials. Accordingly, companies deducting all compensation paid to covered executives should review their compliance with Section 162(m) to ensure that such deductions are legitimate and in compliance with the rules of Section 162(m).

Checklist for 162(m) Compliance

1. Do the members of the compensation committee meet the requirements of “outside directors?”
2. Is the compensation intended to be qualified performance-based compensation?
3. If yes, was it granted under a plan approved by stockholders within the past five years? Does the plan need reapproval?
4. Are the performance goals on which the compensation is payable objective? Are they consistent with the plan approved by stockholders?
5. Were such performance goals established within the first ninety days of the performance period (or before more than twenty-five percent of the performance period has elapsed if sooner)?
6. Have the performance goals been changed?
7. Did the compensation committee certify that the goals were met prior to payment? Is there a written record?
8. Is the compensation payable upon termination of employment or retirement regardless of the satisfaction of the performance goals under the plan or any other arrangement?
9. Were stock option or SAR grants approved by the compensation committee of outside directors?
10. Was the exercise price (or base price on which appreciation is measured for the SAR) equal to the fair market value of the stock on the date of grant?