

Proxy Season Reminders: Section 162(m)

February 28, 2007

As publicly traded companies prepare their 2007 proxy statements and set the parameters for 2007 executive compensation, several issues arise in connection with section 162(m) of the Internal Revenue Code (the Code). Below, we have highlighted issues that may need to be considered this year.

Section 162(m) of the Code imposes a \$1 million annual deduction limit on the compensation paid to the chief executive officer and the four other top- paid officers of a publicly traded company (the “top 5”).* Section 162(m) provides an exception to this deduction limit for performance-based compensation that meets certain requirements. Two types of compensation can qualify as performance-based compensation under section 162(m):

- Annual bonuses, restricted stock, restricted stock units, and other incentive awards, if they are payable or vest based on achievement of objective performance goals under a plan that meets the 162(m) requirements. Among other requirements, the plan must specify the criteria on which performance goals will be based and must specify a maximum amount that may be awarded to an employee during a specified period. The plan must be approved by the shareholders.
- Stock options and stock appreciation rights, if they are granted under a shareholder-approved plan that specifies a maximum number of shares that may be awarded to an employee during a specified period. The plan does not have to specify performance criteria, and vesting does not have to be based on achievement of performance goals. The exercise price of the stock options and stock appreciation rights must be at least equal to the fair market value of the underlying stock on the date of grant.

The following issues arise with respect to section 162(m) performance-based compensation:

- The committee that grants 162(m) performance-based compensation must consist of nonemployee directors who meet special 162(m) requirements. These requirements are different from the NYSE and Nasdaq requirements for independent directors and the SEC

* It should be noted that the recent SEC revisions to the proxy disclosure rules now focus on the company’s CEO, its CFO, and the three other top-paid executives (as well as, under some circumstances, two other executives). In contrast, section 162(m) focuses on the “top 5”. As a result, a company’s group of executives subject to 162(m) may not be identical to its group of executives whose compensation is required to be disclosed in the company’s proxy statement.

requirements for nonemployee directors under Rule 16b-3. Companies should periodically review the membership of the compensation committee to make sure it complies with the 162(m) requirements.

- If the shareholder-approved plan includes performance criteria and the company intends to make grants of 162(m) performance-based compensation based on the performance criteria, the plan must be reapproved by the shareholders every five years. Companies with this type of plan should determine whether their plans need reapproval this year.
- If an executive's annual compensation is expected to exceed \$1 million in 2007, a company may want to consider adopting a 162(m) annual bonus plan and submitting it to the shareholders at its 2007 annual meeting. The performance goals must be established no later than 90 days after the beginning of the performance period (or before 25% of the performance period has elapsed, whichever is shorter). For calendar year companies, this means that the performance goals for an annual plan must be established by March 31, 2007. The plan may be approved by the shareholders after that date.
- Many companies are changing the form of equity grants from stock options to restricted stock units. Unlike options, restricted stock units will be subject to the 162(m) deduction limit when they become taxable, unless the grants vest or are payable based on attainment of objective performance goals under a 162(m) plan. Companies may want to add 162(m) performance criteria to their existing equity compensation plans and submit the amended plans to the shareholders at their 2007 annual meetings.
- Except as to stock option grants (which are deemed to be performance based solely by virtue of being based on stock appreciation), compensation committees must certify that the applicable performance goals have been met in order for bonus amounts or awards earned (including vesting of equity awards) to be deductible under 162(m). Simply issuing the awards or bonuses subject to the performance criteria is not sufficient; compensation committees must certify the results.

Please also note the following:

- We expect that final regulations with respect to deferred compensation plans under section 409A of the Code will be issued in March. Morgan Lewis will be providing updates in the form of LawFlashes, webinars, and other communications when that guidance is released.
- Under current law, a number of companies use deferred compensation arrangements to help solve 162(m) problems. In particular, under current law, payments cause 162(m) issues only when made to executives while then holding a position in the "top 5." A payment made to a former executive who is not in the "top 5" when the payment is received is not subject to 162(m). The Senate Finance Committee passed a provision that would amend 162(m) to eliminate this planning opportunity by requiring, in essence, that once an executive is a member of the "top 5" group, he or she would remain so with respect to amounts earned during that period of service. While the Senate provision did not survive in the most recent tax bill, it may very well resurface in the future.

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