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Section 162(m) Pitfalls

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It's proxy season. For public companies that rely on the performance-based compensation exception to the $1 million annual deduction limit under section 162(m) of the Internal Revenue Code (Code), that means it's time to adopt annual and long-term incentive plans, set performance goals, certify attainment of performance goals from prior-year plans, disclose performance targets, and address the deductibility of executive compensation in their annual Compensation Discussion and Analysis disclosures.

We have highlighted below several common compliance pitfalls that can be fatal to qualifying for the section 162(m) performance-based compensation exception. Public companies should review their performance-based compensation arrangements in light of these pitfalls to maximize their tax deduction for compensation paid to their top executives.

Common Section 162(m) Pitfalls

- **Permitting payment of performance-based compensation upon retirement, involuntary termination, or termination for good reason**. Pursuant to IRS Revenue Ruling 2008-13, compensation payable for performance periods beginning after January 1, 2009 or paid under employment agreements entered into after February 21, 2008 (or that are renewed or extended after that date, including automatic renewals or extensions) will not qualify as performance-based if it may be paid without regard to whether the performance goals are met when the executive retires, is involuntarily terminated without cause, or terminates employment for good reason. This rule applies without regard to whether any of these events actually occur or the performance goals are in fact attained; the mere presence of the provision disqualifies the arrangement.[1] Therefore, companies should review their employment contracts, severance agreements, and other compensation arrangements to see if performance-based arrangements intended to comply with section 162(m) could be payable on retirement, involuntary termination, or termination for good reason.

[1] Compensation may qualify as performance-based even if the plan allows the compensation to be payable upon death, disability, or change of ownership or control without attainment of the performance goals. The regulations also warn that compensation actually paid on account of those events would not qualify as performance-based. However, separate exceptions generally ensure a deduction for such payments, since the payees (after the death or disability of an executive) or the payor (in the event of a change in control) are likely exempt from section 162(m) in any event.

- **Allowing directors who are not "outside directors" to serve on the committee authorizing and administering section 162(m) performance-based compensation.** To qualify as performance-based compensation, compensation must be awarded and administered by a committee composed solely of two or more "outside directors." "Outside directors" are defined as directors who are not former employees or current or former officers (including directors who acted as interim officers depending on the circumstances)[2] and who generally do not receive remuneration other than director compensation from the corporation. Satisfying the NYSE or NASDAQ requirements for independent directors or the SEC requirements for nonemployee directors under Rule 16b-3 (while generally mandatory) is not sufficient—the section 162(m) requirements are different (and can be more restrictive).

- **Using a performance goal that is not based on the business criteria approved by shareholders.** Compensation other than stock options and stock appreciation rights (SARs) granted with an exercise price at least equal to grant date fair market value will qualify as performance-based compensation only if it is paid solely on the attainment of one or more pre-established, objective performance goals, based upon business criteria approved by shareholders. The compensation committee may not deviate from the business criteria listed in the shareholder-approved plan. These criteria need not be specific as to the exact targets being used. For example, the plan need not be so specific as to provide that the performance goal is a 10% increase in earnings per share. Rather, the plan need only provide that the performance goal may be based on earnings per share. However, pursuant to the SEC's compensation proxy disclosure requirements, a company must annually disclose and analyze the specific performance criteria and targets in its Compensation Discussion and Analysis unless the disclosure involves confidential trade secrets or confidential commercial or financial information, the disclosure of which would result in competitive harm to the company.

- **Failing to obtain shareholder reapproval of business criteria upon which performance goals are based.** The specific targets that must be satisfied under a performance goal need not be approved by shareholders. However, if the compensation committee has the authority to change the targets under a performance goal from year to year after shareholders have approved the business criteria upon which performance goals are based, the business criteria must be disclosed to and re-approved by shareholders at least every five years. Therefore, if shareholders last approved the business criteria in a plan in 2005, the business criteria should be submitted to shareholders for reapproval in 2010. The material terms of the performance goals that must be reapproved include (1) the class of eligible employees, (2) the types of business criteria on which the payouts or vesting for performance-based awards are based,

[2] Whether a director who serves as an interim officer qualifies as "outside director" depends on the facts and circumstances. In Revenue Ruling 2008-32, the IRS concluded that a director did not qualify as an "outside director" based on the following facts: (1) the company employed the director for an indefinite period of time to serve as interim CEO with the full authority invested in that office; (2) the director was in regular and continuous service for nearly a year; (3) the director was not employed for a special or single transaction; and (4) the director did not merely have the title of "officer." However, under case law long predating section 162(m), absent one or more of these cited conditions, an "interim officer" may not necessarily meet the definition of "officer," and thus may still qualify as an "outside director."

and (3) the maximum amounts of cash or shares that can be provided during a specified period to any employee for performance-based awards under the plan.

- **Failing to establish the performance goals on a timely basis or making changes to the performance goals or targets.** The performance goals must be established in writing no later than 90 days after the beginning of the service period to which the performance goals relate (or before 25% of such service period has elapsed) and at a time when the outcome is substantially uncertain. For calendar-year service (and performance) periods, this means that the performance goals for an annual plan must be established by March 31, 2010. The performance goals cannot be changed after this initial period.

- **Paying compensation when the performance goals were not attained.** To qualify as performance-based compensation, compensation must be paid solely on the attainment of one or more objective performance goals. In the current economic environment, many companies did not attain their performance goals and may be considering paying their executives discretionary bonuses for their efforts in 2009. A word of caution: a discretionary bonus would not qualify for the performance-based exception, and could also jeopardize the performance-based exception for prior or future bonuses, if the facts and circumstances indicate that performance-based compensation is paid regardless of performance. On the flip side, compensation payable on account of attaining the performance goal must not exceed the limit that was approved by shareholders, and the plan should not provide the compensation committee discretion to pay more than the authorized amount.

- **Adjusting bonus amounts for subsequent events if such an adjustment is not included in the performance goal formula.** To qualify as performance-based, compensation must be payable under an objective formula for computing the amount payable if a certain goal is attained. It is possible to adjust performance measures for certain objective subsequent events (for example, reorganization and restructuring programs or other executive termination costs, integration and other one-time expenditures, the sale or acquisition of a business unit); however, this feature must be included in the performance goal formula when it is initially established, and cannot be added at the end of the performance period. If unanticipated circumstances arise, the compensation committee can use its discretion to reduce the payout to the desired level based on the circumstances, but the payment cannot be increased to disregard the impact of subsequent events if no adjustment mechanism is present.

- **Increasing the amount of compensation that would otherwise be due upon attainment of the performance goals.** Compensation will not qualify as performance-based if the compensation committee has discretion to increase the amount payable upon attainment of the performance goals. However, the committee may have discretion to reduce the payment.

- **Paying awards or bonuses without compensation committee certification that the performance goals were satisfied.** Compensation committees must certify that the performance goals have been met in order for amounts paid upon attainment of those goals to be deductible under section 162(m). This applies to any bonuses or awards, including the vesting of equity awards based on performance. This certification should be included in the compensation committee minutes.

- **Misstating or omitting required terms that must be approved by shareholders for compensation to qualify as performance-based.** The material terms that must be approved by shareholders include the maximum amount of compensation that could be paid to any employee or the formula used to calculate the amount of compensation to be paid to individual employees if certain performance goals are attained, the employees eligible to receive the compensation, and a description of the business criteria on which the performance goals are based. The description of the compensation payable must be specific enough so that shareholders can determine the maximum amount that could be paid to any employee during a specified period. With respect to options and SARs, the plan must state the maximum number of shares with respect to which options or SARs may be granted during a specified period to any employee.

- **Granting stock options or SARs in excess of the plan's limit or the amount that can be awarded to an individual in a specified time period.** Stock options and SARs must be granted under a shareholder-approved plan that contains a limit on the maximum number of options or SARs that may be granted to any employee in a specified period and the exercise price.

- **Allowing inside directors to participate in granting stock options or SARs**. Stock options and SARs must be granted by "outside directors" in accordance with a shareholder-approved plan in order to qualify as performance-based compensation under section 162(m).

- **Granting discounted stock options or SARs.** The exercise price (or measurement) of stock options and SARs intended to qualify with section 162(m) (and to be exempt from Code section 409A) must not be less than the fair market value of the underlying stock on the grant date—the amount of the compensation that the employee can receive must be based solely on an increase in the value of the stock after the grant date. A recent IRS generic Legal Advice Memorandum, dated July 6, 2009, emphasizes that discounted stock options or SARs can never qualify as performance-based compensation under section 162(m) and states that discounted options and SARs cannot be cured for purposes of qualifying as performance-based compensation under section 162(m).

- **Not contemporaneously documenting stock option and SAR grants or failing to document grants altogether.** Even though the section 162(m) regulations do not require formal committee meetings to grant options or SARs or even prompt documentation of those grants, on audit the IRS has taken the position that options are discounted (and thus do not qualify as performance-based compensation under section 162(m)) when grants are documented weeks after the grant date using "as of" grant dates or unanimous written consents (UWCs), when there is no contemporaneous documentation of compensation committee meetings or when there are only oral authorizations from the board or the compensation committee. In the event that the IRS determines that it is not possible to determine the grant date, the IRS will use the financial accounting measurement date as a proxy for the grant date. To avoid this challenge, the compensation committee should be precise about when an option or SAR is granted and complete all corporate documentation in a timely manner, for example, by preparing, signing, and dating the committee minutes or UWCs at the committee meeting, or within a day or two after the meeting or after the decision is made to grant options or SARs. This also raises a question about "best practices" for granting equity compensation.

Other Pitfalls

- Granting stock options or SARs or paying other compensation under a plan that was not approved by shareholders.
- Materially amending a plan without shareholder approval.
- For companies having an IPO, failing to obtain shareholder approval of a pre-IPO plan before the first shareholders meeting following the end of the third calendar year after the IPO.
- Accelerating the payment date of performance-based compensation without reducing the payment amount to reflect the time value of money.

Planning Opportunities

- Companies can mitigate the adverse effect of failing to comply with section 162(m) by requiring deferrals of any amounts that would not be deductible by the company to a date after the employee's termination of employment. Forcing executives to assume the credit risk in difficult economic times may be met with resistance, however. Also, keep in mind that any such deferral must be made in accordance with section 409A.
- Companies should consider instituting clawback policies with respect to performance-based compensation. A clawback policy allows the company to recover compensation if subsequent review indicates that payments were not calculated accurately or performance goals were not met.

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