

Morgan Lewis

Section 162(m) Compliance
Overview and Update 2010

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The Performance-Based Exemption From The 162(m) Deduction Limitation

- Renewed IRS interest in section 162(m) compliance
- Policies and procedures for meeting the basic exemption requirements
- Setting compliant performance goals and “service periods” that qualify for exemption
- Effectively maintaining a committee of “outside directors”
- Documenting actions to ensure a proper compliance record
- 162(m) Hot Topics
- Q&A

Section 162(m)

- Limits deductible compensation paid to certain officers of publicly held companies to \$1 million
 - CEO and the 3 highest compensated officers (other than CFO)
 - On the last day of the taxable year
- Performance-based compensation exemption
 - Different rules apply to options/SARs and other forms of compensation

Performance-Based Compensation

- Performance Goals
 - Paid solely on account of attainment of one or more pre-established objective performance goals, pursuant to an objective formula
- Compensation Committee
 - Performance goals must be established by a compensation committee that consists solely of 2 or more “outside directors”
- Shareholder Approval
 - Material terms governing payment of the compensation must be disclosed to, and approved by, shareholders prior to payment
- Certification
 - The compensation committee must certify, in writing, prior to payment, that the performance goals and any other material terms were satisfied

Performance Goals

- Pre-established
 - Established in writing
 - By the compensation committee
 - No later than 90 days after the beginning of the service period to which the performance goal relates or before 25% of such service period has elapsed
- Outcome must be substantially uncertain

Performance Goals

- Objective
 - A third party having knowledge of relevant facts could determine if the goal is met
- State, pursuant to an objective formula or standard, the method for computing the amount of compensation if the goal is attained
 - No discretion to increase amount of compensation; negative discretion is permitted
 - If percentage of salary or base pay, the amount of salary or base pay has to be fixed at the time the goal is established or the plan has to include a maximum dollar amount that can be paid
 - Adjustments for certain objective subsequent events (e.g., reorganization or restructuring programs, executive termination costs, the sale or acquisition of a business unit, other one-time expenditures)

Performance Goals

- Payment must be contingent on attainment of the performance goal
 - Cannot receive all or part of the compensation regardless of whether the performance goal is attained
 - If payment date is accelerated, reduce payment amount to reflect the time value of money
- Death, Disability, Change in Control

Performance Goals

- Termination (without cause, for good reason, retirement)
 - Revenue Ruling 2008-13
 - *Performance periods beginning after January 1, 2009*
 - *Employment contracts entered into after February 21, 2008*
 - *Amendments to or renewals or extensions of employment contracts in effect on February 21, 2008*
- Going forward
 - Avoid amendments to grandfathered agreements
 - Limit payment to the pro rata amount that would otherwise be payable on achievement of performance goals
 - *Payment delayed until end of performance period*

Compensation Committee

- Committee consisting of 2 or more “outside directors”
 - Officer of the company
 - *Interim Officers (Revenue Ruling 2008-32)*
 - Current employee of the company
 - Former employee of the company who is receiving compensation for prior services (other than under a qualified retirement plan)
 - Payment from the company, directly or indirectly, in any capacity other than as a director
 - *Exception for certain de minimis remuneration*

Shareholder Approval

- Material terms of the performance goal
 - Class of eligible employees
 - Business criteria on which the performance goal is based
 - Maximum amount of compensation that could be paid to any employee or the formula used to calculate the amount of compensation
- Shareholder reapproval
 - Material terms are changed
 - If the committee has authority to change the targets under a performance goal after shareholder approval of the goal
 - *Every 5 years*

Shareholder Approval

- Transition Periods
 - Length depends on how the corporation becomes publicly held
 - Adoption of material plan amendments
- IPO
 - 1st shareholder meeting following the end of the 3rd calendar year after the IPO
 - *Shareholder approval required in 2010 for IPO in 2006*
- Other
 - 1st calendar year after the calendar year in which the corporation becomes publicly held

Certification

- The compensation committee must certify, in writing, prior to payment, that the performance goals and any other material terms were satisfied
 - Approved minutes of the compensation committee
- Internal controls
 - Whether performance targets are attained
 - Whether payments are calculated accurately
 - Recover compensation if subsequent review indicates that targets were not actually met

Options and SARs

Performance goal requirement is met if:

- Compensation committee authorizes the grant
- The plan states maximum number of shares to which options/SARs can be granted during a specified period to any employee
- The exercise price of the option or base amount for the SAR is not less than grant date FMV of underlying shares
- Granted under a shareholder-approved plan

Certification not required

Options and SARs

- Shareholder approval requirement is met if shareholders approve:
 - Maximum number of shares that can be granted to any employee during a specified period
 - Class of eligible employees
 - Exercise price
- Amendments to material terms

Options and SARs

- The amount of compensation must be based solely on an increase in stock value after the grant date
- IRS Generic Legal Advice Memorandum (July 6, 2009)
 - Discounted options or SARs can never qualify as performance-based compensation
 - Discounted options or SARs cannot be cured for purposes of qualifying as performance-based compensation
- IRS Audits

Options and SARs

- Compliance Issues
 - Ratification by full Board
 - Recusal or abstention by inside directors
 - Delegation to management
 - Documentation
 - Grant Date
 - *ISO and section 409A standards*
 - the date the corporation completes the corporate action constituting an offer and sale to an individual of a certain number of shares at a fixed price per share
 - *Financial accounting measurement date*
 - Grant date fair market value

Restricted Stock and RSUs

- Grants must vest or become payable based on attainment of objective performance goals under a 162(m) shareholder-approved plan
- Must include 162(m) performance criteria in equity compensation plan

162(m) Hot Topics

- Option cancellation and repricing
- Clawbacks
- Plan within a plan or “umbrella” plan
- Legislation (Senate finance health reform, covered employees, TARP limits)
- Deduction timing (CCA 200949040)
- Employment Tax Audit Program

Employment Tax Audit Program – National Research Program

- February 2010
- 2,000 taxpayers, randomly selected each year for 3 years
 - Small and large business, tax-exempt, and government sectors
- Audits based on the Form 941

Employment Tax Audit Program – National Research Program

Trending information for:

- Officers' compensation
- Worker classification
- Fringe benefits
- Employee expense reimbursement plans
- Nonfilers

Questions?

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