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Global Benefits & Compensation | Alert

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Section 162(m): Actions that Should be Taken by March 30, 2016, and/or in this Year's Proxy to Avoid the $1,000,000 Deduction Limitation

This *GT Alert* serves to remind our publicly held clients of things that need to be done early this year to minimize or avoid the application of the deduction limitations imposed by Section 162(m) of the Internal Revenue Code of 1986, as amended. The *Alert* also provides an overview of the basic principles contained in Section 162(m).

<u>Actions to be Considered</u>

The actions that should be considered early this year include the following:

> For performance-based bonuses and other compensation for 2015 to qualify as "performance- based compensation" that is exempt from Section 162(m), the Compensation Committee must certify in writing that the performance goals have been satisfied before the bonuses or other compensation is paid.

> To be exempt from the Section 162(m) deduction limitations, the Compensation Committee must set the performance goals during the first 90 days of the performance period. Thus, for a performance award for calendar year 2016, **the goals must be set no later than March 30, 2016**.

> Most incentive compensation plans do not prescribe a formula for performance awards, but rather only specify the objective performance criteria upon which performance-based compensation may be based. Actual metrics, targets, and awards are typically set by the Compensation Committee each year using those criteria. For such a plan, the employees eligible to receive awards, the performance criteria used to establish performance goals, and the maximum awards that may be granted to any individual must be re-approved by shareholders every five years. **Thus, if your incentive compensation plan was last approved by shareholders in 2011 (or earlier), your shareholders may need to re-approve the eligibility requirements, performance criteria, and maximum awards this proxy season for the bonuses and other compensation to be deductible without regard to the Section 162(m) deduction limitations.**

- Shareholder approval also may be required this year if your company went public after 2011 as a result of an initial public offering (or was recently spun-off from another publicly-held company).

Compensation will not qualify as performance-based compensation if the performance conditions are deemed to be satisfied where a covered employee's employment is terminated for reasons other than the employee's death or disability or in the event of a change in control. **Therefore, incentive compensation plans and other agreements that provide for performance goals to be deemed satisfied if other events occur, (such as termination by the company without cause, termination by the employee for good reason, or the employee's retirement) should be reviewed and revised, if necessary, to avoid this result.**

Overview of Section 162(m) Principles

General Rules. Section 162(m) generally provides that a publicly held corporation may not deduct compensation with respect to its CEO or its three next most highly compensated officers other than its principal financial officer (each a covered employee) to the extent that the amount of the compensation payable to the covered employee for the taxable year exceeds $1,000,000. Compensation that qualifies as "performance-based compensation," however, is disregarded in applying the $1,000,000 limitation. To qualify as performance-based compensation, the following requirements must be met:

- The compensation must be paid solely on account of the attainment of one or more pre-established, objective performance goals;
- The goals must be established by a committee comprised solely of two or more outside directors (the Committee);
- The goals must be established in writing not later than 90 days after the beginning of the performance period (but, in no event, after 25 percent of the performance period has run) and at a time when the outcome is substantially uncertain;
- The Committee may not retain discretion to increase the award, although an award, once determined on the basis of objectively determinable criteria, may be reduced in the discretion of the Committee;
- The "material terms" of the award must be disclosed to, and subsequently approved by, the company's shareholders; and
- Before the payment of the compensation, the Committee must certify in writing that the performance goals have been satisfied.

Treasury Regulations indicate that the "material terms" that must be approved by shareholders include: (i) the employees eligible to receive compensation, (ii) a description of the business criteria on which the performance goals are based, and (iii) either the maximum amount of compensation that can be paid to any employee, or the formula that is to be used to calculate the amount of compensation to be paid, if the performance goals are attained.

Treasury Regulations also indicate generally that compensation attributable to a stock option or a stock appreciation right (SAR) is deemed performance-based compensation if:

- the grant or award is made by the Committee;
- the plan under which the option or right is granted states the maximum number of shares with respect to which options or rights may be granted during a specified period to any employee; and
- the exercise price of the option (or base value for measuring the value of the SAR) is not less than the fair market value of a share on the date the award is granted.

Restricted stock and other equity awards that do not qualify for this special rule (*e.g.*, discounted stock options)[1] will not qualify as performance-based compensation unless the general requirements under Section 162(m) summarized above are met.

Payment Must Be 'Solely' on Account of Attainment of Performance Goals

Umbrella Arrangements

In recent years, economic uncertainties have made it particularly difficult for Committees to set appropriate performance goals. Treasury Regulations provide that compensation will not qualify as performance-based compensation, and thus will be subject to the Section 162(m) deduction limitation, if the Committee may increase the amount of compensation that otherwise would be due upon attainment of the goal, or if the facts and circumstances indicate that the employee would receive all or part of the compensation regardless of whether the performance goal is attained. The Treasury Regulations also indicate that if the payment is only nominally or partially contingent upon attainment of the performance goals, then none of the compensation will be considered performance-based. Thus, any bonus in excess of that derived from the formula set by the Committee would be subject to the Section 162(m) deduction limit (and the structure of the arrangement itself could jeopardize the ability of the the portion of the bonus that is derived from the formula to qualify as performance-based compensation).

The Treasury Regulations indicate, however, that compensation will not fail to qualify as performance-based compensation as a result of the Committee's exercise of "negative discretion." One approach that utilizes the Committee's exercise of negative discretion is known as an "umbrella" plan. Pursuant to this arrangement, the Committee first would set performance goals that, if met, will serve as the maximum amount of performance-based compensation that may be paid to an executive (*e.g.*, 1 percent of net income) for the year. The Committee then would establish other objective and subjective performance targets that it would use to determine the actual amount of the bonus that would be payable to each executive, and would exercise its negative discretion to reduce the amount of the bonus from the maximum that was determined under the umbrella formula to the amount that it determines to be an appropriate bonus for each executive. Structuring the bonus arrangements in this way may enable the Committee to have some flexibility in determining bonuses without jeopardizing the deductibility of those bonuses under Section 162(m).

Before adopting this approach, a Committee should consider the manner in which this arrangement should be disclosed in the Compensation Discussion and Analysis in the company's Proxy statement.

Rev. Rul. 2008-13

In Rev. Rul. 2008-13, the IRS held that compensation was not payable "solely" on account of satisfaction of the pre-established performance goals pursuant to an employment agreement between the employer and a covered employee, if the agreement also provided that the performance goals would be deemed to be satisfied where a covered employee's employment was terminated by the employer without "cause," or by the employee for "good reason," or by reason of the employee's retirement. Therefore, the compensation would not qualify as performance-based compensation even if the goals, in fact, were achieved, or the employee's employment did not terminate for one of those reasons. The IRS noted that Treasury Regulations only permit the goals to be waived in the event of the employee's death or disability, or a change of ownership or control of the company.

The principles set forth in Rev. Rul. 2008-13 generally were effective for periods of service beginning after Jan. 1, 2009. If, however, the payment on involuntary termination is made pursuant to the terms of an employment agreement that was in effect on Feb. 21, 2008, compensation will not fail to be qualified performance-based compensation if it is payable before the agreement comes up for renewal.

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[1] Discounted stock options and discounted SARs are also potentially subject to the restrictions on deferred compensation imposed under Section 409A. Therefore, care must be taken to ensure either that they are structured to qualify for an exception to Section 409A (such as the short-term deferral exception) or that they satisfy the requirements of Section 409A (such as by requiring that they be exercised only at times permitted as distribution events under Section 409A).

In any event, these rules need to be considered in the preparation of new plans and employment agreements. In this regard, notwithstanding the conclusion set forth in Rev. Rul. 2008-13, employers can provide some level of protection with respect to incentive compensation for executives who are involuntarily terminated or who retire. Although the target amount of the actual incentive award for the termination year, determined as if the target performance goals had been met, cannot be payable to the executives under those circumstances without jeopardizing the deductions for payments made upon satisfaction of the performance goals, an employment agreement should be able to provide that some other amount (*e.g.*, a payment equal to the average of the bonuses paid to the executive over a period preceding termination) will be paid upon an involuntary termination or retirement. Such a provision arguably does not cause the amount that is contingent upon the satisfaction of performance criteria for the year of the executive's termination to be paid without regard to those criteria; instead, a different amount, and one that relates to performance in previous years, would be paid to the terminating executive.

In this case, the amounts paid upon termination before the satisfaction of the performance goals will, as under the law before Rev. Rul. 2008-13, not be qualified performance-based compensation. The payments should nevertheless be deductible because according to the Treasury Regulations, the person to whom they are paid will not be a covered employee for Section 162(m) purposes if he or she is not employed on the last day of the year in which the payment is made.

Need for Shareholders to Re-approve Certain Plans

Re-approval by Shareholders Generally Required Every Five Years

Once the material terms of the performance goals have been disclosed to and approved by shareholders, no additional disclosure or approval generally is required, unless the Committee changes the material terms of the performance goals. However, the Treasury Regulations provide that if the Committee has the ability to change the specific targets under a performance goal, then the material terms of that performance goal must be disclosed and re-approved by shareholders no later than the first shareholder meeting that occurs in the fifth year following the year in which shareholder approval was last obtained.

To provide flexibility for Committees in structuring effective incentive compensation arrangements for executives, most incentive compensation plans merely set forth the types of business criteria that Committees may use in developing bonus formulas or other performance-based compensation each year (rather than including a specific performance formula in the plan).

Thus, if your company has taken this approach in its incentive compensation plan, and the material terms under your plan were last approved by shareholders in 2011, then your company will need to resubmit the material terms of its performance awards under its plan for re-approval by shareholders this year for performance-based compensation paid after 2016 to be excused from the scope of Section 162(m).

Approval by Shareholders of Companies that Recently Became Publicly Held Corporations

Section 162(m) also contains some transitional exceptions for corporations that become publicly held that may be expiring for some plans:

> ***Reliance Period for Corporations that Become Publicly Held Corporations***

Section 162(m) generally does not apply during a "reliance period" to compensation paid pursuant to a plan or agreement that existed during the period in which the corporation was not publicly held. The reliance period ends on the earliest of: (i) the expiration of the plan or agreement; (ii) the material modification of the plan or agreement; (iii) the issuance of all employer stock and other compensation that has been allocated under the plan; and (iv) the first meeting of shareholders at which directors are to be elected that occurs after the close of the third calendar year following the calendar year in which the initial public offering (IPO) occurs or, in the case of a corporation that becomes publicly held without an IPO, the first such meeting of shareholders that occurs after the close of the first calendar year following the calendar year in which the corporation becomes publicly held.

> ***Transition Period for Subsidiaries that Become Separate Publicly Held Corporations***

If a subsidiary of a publicly held corporation becomes a separate publicly held corporation (whether by spin-off or otherwise), any compensation paid to covered employees of the subsidiary will be deemed to satisfy the exception for performance-based compensation during a "transition period" if certain requirements are met. The requirements for this relief and the availability of a "transition period" depend on the facts, but if the new company is a member of an affiliated group that includes a public company, the applicable transition period likely ends no later than the first regularly scheduled meeting of the shareholders of the new publicly held corporation that occurs more than 12 months after the date the corporation becomes a separate publicly held corporation.

Companies that recently became publicly held corporations and former subsidiaries of publicly held corporations that recently have become separate publicly held corporations should review their executive compensation plans to determine whether the "reliance period" or "transition period" afforded under the regulations has expired or is about to expire, and determine whether it would be advisable to submit those plans for shareholder approval during this proxy season.

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