



# Section 162(m): Limit on Compensation

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This Note provides a summary of the \$1 million deduction limitation on certain employee compensation imposed on publicly held companies by Section 162(m) of the Internal Revenue Code of 1986. This Note also addresses the exception from the \$1 million deduction limitation for qualified performance-based compensation.

Publicly held corporations should consider the effects of Section 162(m) of the Internal Revenue Code (IRC) when negotiating executive compensation packages, during the corporate tax planning process, and in establishing overall employee incentive programs designed to maximize shareholder value.

Section 162(m) prohibits publicly held corporations from deducting more than \$1 million per year in compensation paid to each of certain covered employees. To assist publicly held corporations in preparing for the effects of Section 162(m), this Note explains the rules relating to Section 162(m), including the:

- Employees that are covered.
- Types of compensation that are subject to Section 162(m).
- Requirements that need to be met for certain types of compensation to be exempt from the deduction limit.
- Relationship between Section 162(m) and other tax rules that separately impact executive compensation.

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## COMPANIES SUBJECT TO SECTION 162(M)

Generally all corporations that are publicly held on the last day of their taxable year are subject to the \$1 million deduction limit under Section 162(m).

A publicly held corporation is any corporation that issues any class of common equity securities required to be registered under Section 12 of the Securities Exchange Act of 1934, as amended. A corporation is not considered publicly held if the registration of its equity securities is voluntary.

## AFFILIATED GROUP OF CORPORATIONS

All members of an affiliated group of corporations are considered publicly held if any member of the group is publicly held. Any subsidiary that is itself a publicly held corporation is subject to Section 162(m) and all of its subsidiaries are separately subject to Section 162(m) as well.

## PARTNERSHIPS

Several Internal Revenue Service (IRS) private letter rulings address how Section 162(m) applies to the compensation that a publicly held corporation's covered employee (see *Covered Employees*) receives from a partnership in which the corporation has an ownership interest for services the employee performs for the partnership. The IRS ruled that the Section 162(m) deduction limitation does not apply to the:

- Partnership, for compensation it paid to the covered employee for services performed as an employee of the partnership.
- Corporation, for its distributive share of income or loss from the partnership that includes compensation expenses for services performed by the covered employee as an employee of the partnership.

### SITUATIONS WHEN SECTION 162(M) DOES NOT APPLY

Section 162(m) does not apply to:

- Short tax years ending with mergers, where the acquired company is not required to comply with the Exchange Act's executive compensation disclosure rules for the short tax year.
- Foreign private issuers that are not subject to the Exchange Act executive compensation disclosure rules.

### COVERED EMPLOYEES

Covered employees are determined based on the requirements of the SEC executive compensation disclosure rules. Failing to comply with the SEC executive compensation disclosure rules does not justify a failure to comply with Section 162(m).

Covered employees under Section 162(m) include:

- The chief executive officer (CEO) (or an employee acting in that capacity) of the corporation.
- The three highest compensated officers (excluding the CEO and the principal/chief financial officer (PFO/CFO)).

Only executives employed by the corporation on the last day of the taxable year are covered.

In a private letter ruling (PLR), the IRS held that an employee, who resigned as the corporation's president and CEO to become a senior advisor, was not a covered employee under Section 162(m) because the employee was not an executive officer on the last day of the tax year. However, even though the employee was not an executive officer on the last day of the tax year in question, the employee's compensation was required to be disclosed by the SEC executive compensation disclosure rules because the employee served as a CEO for a portion of the tax year (*PLR 200836010*).

### COMPENSATION

Compensation for Section 162(m) purposes is the aggregate amount paid to the executive:

- For services performed as a covered employee.
- That is allowed as a deduction by the corporation for the taxable year (determined without regard to the \$1 million limit imposed by Section 162(m)).
- Regardless of whether the services were performed during the taxable year.

The \$1 million deduction limit is not reduced because the employer (newly formed as a result of a spin-off) has a short taxable year (*PLR 9810024*).

### EXCLUDED COMPENSATION

Certain types of compensation are excluded from the compensation subject to Section 162(m):

- Retirement income from a qualified plan or annuity.
- Benefits that are excluded from the executive's gross income (for example, certain welfare benefits).
- Commission-based compensation (see *Commission-based Compensation*).
- Qualified performance-based compensation (see *Qualified Performance-based Compensation*).

For example, the CEO of a publicly held corporation retired and then reassumed his duties within the same tax year. While retired, he received certain payments from the corporation, which included payments:

- From a qualified plan.
- For non-employee consulting with the corporation.
- As a director of the corporation.

Because the pension payments were from a qualified plan, the IRS held that the payments were not subject to the Section 162(m) deduction limitation. In addition, because the other two payments were for services that were not performed as a covered employee, the IRS held that those payments were also not subject to the Section 162(m) deduction limitation.

### COMMISSION-BASED COMPENSATION

The Section 162(m) limitation on deductible compensation does not apply to commission-based compensation generated directly by the individual (not a group or business unit).

However, in a private letter ruling, the IRS held that a bonus paid to an individual for that individual's contributions as part of a team that obtained a commission for the team's efforts qualified for the commission-based compensation exception (*PLR 200541033*).

### QUALIFIED PERFORMANCE-BASED COMPENSATION

The Section 162(m) limit on deductible compensation also does not apply to compensation that is qualified performance-based compensation. The determination of whether compensation is performance-based is made on a grant-by-grant basis. To qualify for the performance-based compensation exception, payment of the compensation must meet the following requirements:

- **Performance goals.** The compensation must be contingent on the attainment of one or more "pre-established," objective performance goals (see *Performance Goals*).
- **Compensation committee.** The performance goals must be set by the corporation's compensation committee (see *Compensation Committee*).



- **Shareholder approval.** Before payment, shareholders in a separate vote must approve the compensation terms, including the applicable performance goals and the maximum amount payable to any covered employee (see *Shareholder Approval Requirements*).
- **Compensation committee certification.** Before payment, the compensation committee must certify in writing that the performance goals and any other material terms were in fact satisfied (see *Certifying Achievement of Performance Goals*).

## PERFORMANCE GOALS

To qualify for the exception, the performance goal must be:

- Based on business criteria, which may apply to an individual, unit, corporation or a combination of these. The goal does not necessarily have to be based on a positive result, but goals that are substantially certain to be achieved may not be used.
- Based on an objective formula, so that a third party could calculate the award with knowledge of the relevant performance results. If a formula specifies that payment is based on current salary, the objective formula requirement is satisfied if the maximum dollar amount that could be paid is fixed at the time that the performance goal is established. For example, the award is based on the salary in effect after the start of the performance cycle (and after the 90-day grace period), but a maximum dollar amount is set within the 90-day period.
- Established before or soon after the performance period starts. This means that the goal must be set by the earlier of:
  - 90 days after the beginning of the performance period; or
  - before 25% of the period has passed.

In a private letter ruling, the IRS clarified that a compensation committee, which establishes the maximum grant that may be made to each participant in an incentive plan within the first 90 days of the performance period and specifies the applicable performance goals for each individual, may wait until after the 90-day period to determine the actual grant amounts for each participant without causing the compensation to fail to qualify for the performance-based compensation exception (*PLR 200949005*).

If payment of compensation is only nominally or partially contingent on attaining a performance goal, none of the compensation payable under the grant is considered performance-based. Specifically, if a plan has a non-performance-based component that will be paid whether or not the performance-based component is met, none of the compensation is considered performance-based. However, bifurcated plans with components that are not interdependent are considered separately, even if paid from the same bonus pool.

## More than One Performance Goal

If more than one performance goal is pre-established, the compensation committee's discretion to choose to pay a bonus under one of the goals does not cause the plan to fail to meet

the performance-based requirements if each goal independently meets the requirements.

Similarly, shareholders could approve a number of different business criteria for setting performance goals and allow the compensation committee to select the criteria each year. However, the use of multiple criteria generally requires re-approval of the goals by shareholders at least every five years.

## Adjusting Performance Goals

When a shareholder-approved plan provides that a performance goal will be adjusted in the case of an unforeseen event, adjusting that performance goal in accordance with the plan does not constitute an exercise of impermissible discretion and the performance-based compensation exception under Section 162(m) still applies.

## COMPENSATION COMMITTEE

A corporation's compensation committee is the committee of directors (including any subcommittee of directors) that has the authority to establish and administer the applicable performance goals, and certify that the performance goals are met. The committee must consist solely of two or more outside directors.

## Outside Directors

To be a qualified outside director, the director cannot:

- Be a current employee of the corporation.
- Be a former employee who receives compensation for prior service other than benefits under a qualified plan.
- Be a former officer of the corporation (see *Officer*).
- Receive remuneration directly or indirectly from the corporation in any capacity other than as a director.

For example, the IRS held that an individual does not qualify as an "outside director" of a corporation when the individual has served as the corporation's interim CEO in regular and continued service with the full authority vested in that office (*Revenue Ruling 2008-32*).

In addition, certain remuneration received as a director also disqualifies the individual from being an outside director if it is paid in the:

- Current year, to an entity in which the director has a more than 50% ownership interest.
- Preceding year, to an entity in which the director has a more than 5% but less than 50% ownership interest (unless the remuneration is *de minimis*).
- Preceding year, to an entity by which the director is employed or self-employed other than as a director (unless the remuneration is *de minimis*).

Remuneration is considered *de minimis* if it is 5% or less of the receiving entity's gross revenue (for its taxable year ending with or within the preceding taxable year of the publicly held corporation). However, it must also not exceed \$60,000 if paid:

- To an entity in which the director owns between 5% and 50%.
- For legal, accounting, investment banking or management consulting services performed by an organization for which the director performs significant services.

### Officer

Determining whether an individual is or was an officer is based on all of the facts and circumstances in the particular case, including the:

- Source of the individual's authority.
- Term for which the individual is elected or appointed.
- Nature and extent of the individual's duties.

### SHAREHOLDER APPROVAL REQUIREMENTS

Performance-based compensation does not qualify for exclusion from the Section 162(m) deduction limitation unless the material terms of the plan are disclosed to and approved by the shareholders before the compensation is paid. The following terms must be disclosed:

- **Eligible employees.** A description by title or class is sufficient (all key employees). Individual names do not need to be disclosed.
- **Business criteria.** The type, but not the actual targets, of the goal or goals (for example, earnings per share, total shareholder return or return on equity). Compensation based on stock options or stock appreciation rights (SARs) granted with an exercise price at least equal to fair market value on the grant date is exempt from this disclosure.
- **Maximum compensation.** The maximum amount of compensation payable during a specified period or the formula for calculating the compensation must be disclosed (see *Maximum Compensation*).

The shareholder approval requirement is not satisfied if the compensation would be paid regardless of whether the material terms are approved by shareholders.

In certain circumstances, a bankruptcy court's approval of performance-based incentive plans is deemed to meet the shareholder approval requirements of Section 162(m).

### Maximum Compensation

Generally the maximum amount of compensation to be paid during a specified period or under a formula must be disclosed to shareholders for their approval. However, a company need not disclose a specific dollar amount of compensation payable to a covered employee if the company's disclosure is sufficient for shareholders to determine the maximum dollar amount payable based on achievement of applicable performance goals. For

example, the specific dollar amount need not be disclosed if a bonus is payable as a percentage of an officer's base salary and the company discloses:

- The formula used to calculate the amount of compensation to be paid to the officer if the performance goal is achieved.
- That the maximum dollar amount of compensation is based on the base salary of the officer at the beginning of the applicable performance period.

For options or SARs, the maximum number of shares that can be granted per employee during a specified period and the exercise price (for example, fair market value at the date of grant) must be disclosed. For other equity-based awards, the maximum number of shares that can be granted per employee during a specified period must be disclosed.

### Disclosure of Confidential Information Not Required

The disclosure of a material performance goal is not required if the compensation committee determines that the information is confidential commercial or business information, the disclosure of which would have an adverse effect on the company. Confidential information does not include the identity of an executive or the class of executives to which a performance goal applies or the amount of compensation that is payable if the goal is satisfied.

### Frequency With Which Material Plan Terms Must Be Disclosed to Shareholders

Once the material terms of a plan are approved by shareholders, no additional disclosure is required unless the compensation committee changes the material terms of the performance goal. If, however, the committee has the authority to change the targets under a performance goal, the material terms of the plan must be re-approved by shareholders by the first shareholder meeting that occurs in the fifth year after the year that the shareholders previously approved the performance goal.

When an acquiror acquires a company with a plan that has already been approved by the acquired company's shareholders and the acquiring company assumes the plan and extends it to cover some of its own employees, the plan continues to meet the shareholder approval requirement of Section 162(m). There is no need to have the plan reapproved by the acquiring company's shareholders as a result of the acquisition.

### CERTIFYING ACHIEVEMENT OF PERFORMANCE GOALS

The compensation committee must certify in writing that the performance goals and any other material terms are satisfied before compensating a covered employee. Approved minutes of the compensation committee meeting in which certification is made are treated as written certification. Certification is not required for compensation attributable solely to the increase in the corporation's stock value (for example, compensation paid on exercise of stock options or SARs).



The compensation committee can use its discretion to reduce or eliminate the award otherwise payable to a covered employee under the formula, but not increase it.

## TYPES OF PERFORMANCE-BASED COMPENSATION

Only certain types of compensation can qualify for the performance-based compensation exception to Section 162(m).

### BONUSES

Bonuses that are paid based on a percentage of a corporation's annual sales are not substantially uncertain enough to be performance-based because the corporation is virtually certain to have some sales for the fiscal year.

However, bonuses that are paid based on a percentage of a corporation's annual profits (or related measures) are substantially uncertain and are, therefore, performance-based. This is the case even if the company has a history of profitability.

In the case of a bonus pool, if the amount payable to each covered employee is stated in terms of a percentage of the pool, the sum of the individual percentages of the pool may not exceed 100%, and the failure to pay someone his full percentage may not result in an increased payment to another covered employee.

### EQUITY COMPENSATION AWARDS

For a grant of stock options, SARs, restricted stock or restricted stock units (RSUs), to qualify as performance-based compensation for purposes of Section 162(m), the grant must be made:

- By the compensation committee (see *Compensation Committee*).
- Under a plan that specifies the maximum number of shares that may be granted to any individual employee during a specified period. An overall plan limit is not sufficient to meet this requirement; an explicit individual limit is required.
- In the case of stock options and SARs, the compensation received must be based solely on an increase in the value of the stock after the grant date (and therefore the exercise price must be no lower than the fair market value of the underlying stock on the grant date).

On June 23, 2011, the IRS proposed regulations under Section 162(m) (**Proposed Regulations**) which clarify that if a plan document sets out the maximum number of shares that may be granted under the plan but does not include the maximum number of stock options or SARs that may be granted to any individual employee during a specified period, the stock options and SARs will not be qualified performance-based compensation. It appears permissible under the Proposed Regulations for the per-person limit to be the same as the maximum number of shares available under the plan.

In the case of stock options and SARs, if the above requirements are met, neither the grant nor vesting of the award must be contingent on attaining a qualifying performance goal. Options that are cancelled or repriced reduce the maximum number of shares for which options may be granted to the employee.

However, grants of restricted stock or RSUs cannot qualify as performance-based compensation unless the grant or vesting is contingent on attaining a qualifying performance goal.

### Dividends

Dividends or dividend equivalent rights paid on qualified performance-based restricted stock and performance shares do not disqualify the plan from being performance-based compensation. However, the dividends and dividend equivalent rights themselves are subject to the Section 162(m) deduction limit unless they are granted or earned on the basis of performance and otherwise satisfy the requirements of Section 162(m).

Dividend equivalent rights paid on options do not disqualify the options from being performance-based compensation, but only if the payment of the dividend equivalent rights is not conditioned on the employee exercising the options. Otherwise, the IRS considers the payment of dividend equivalent rights to be similar to a reduction of the option purchase price and that effectively creates a "discounted" option.

### Modifying Stock-based Compensation Awards

Changes to a stock option, SAR or other stock-based compensation do not cause the compensation to fail to qualify as performance-based to the extent that the change in the grant or award is made to reflect a change in the following:

- A corporate capitalization, such as a stock split or dividend.
- A corporate transaction, such as a merger of a corporation into another corporation.
- Any consolidation of two or more corporations into another corporation.
- Any separation of a corporation (including a spin-off or other distribution of stock or property by a corporation).
- Any reorganization of a corporation (whether or not the reorganization is within the definition of such term in Section 368 of the IRC).
- Any partial or complete liquidation by a corporation.

When permitted by the plan, the number and exercise price of options can be adjusted to reflect the impact of corporate events, and the requirements of Section 162(m) are met if the adjustments are made in a manner that is consistent with the methodology provided in Section 424(a) (relating to corporate reorganizations and liquidations) of the IRC.

### Accelerating Stock Option Exercisability

Amending outstanding options to accelerate their exercisability does not cause them to fail to qualify as performance-based compensation.

## COMPENSATION THAT IS NOT PERFORMANCE-BASED COMPENSATION

Certain types of compensation do not qualify as performance-based compensation, including the following.

### PAYMENTS ON DEATH OR DISABILITY

Compensation does not fail to qualify as performance-based compensation merely because the plan allows for payment on death or disability. However, payment actually made on account of one of these events before attainment of the performance goal does not qualify as performance-based and is subject to the Section 162(m) limit.

### PAYMENTS ON TERMINATION WITHOUT CAUSE, RESIGNATION FOR GOOD REASON OR RETIREMENT

Compensation fails to qualify as performance-based compensation if the plan provides that compensation is paid regardless of whether the performance goal is met in these situations:

- The covered employee:
  - is involuntarily terminated by the corporation without cause; or
  - terminates his employment for good reason.
- The covered employee retires.

Two exceptions to this rule allow a deduction for compensation paid on involuntary termination of employment, termination for good reason or retirement and that otherwise satisfies the requirements for qualified performance-based compensation if either the:

- Performance period for the compensation begins on or before January 1, 2009.
- Compensation is paid according to the terms of an employment contract as in effect on February 21, 2008 (without regard to future renewals or extensions, including renewals or extensions that occur automatically without further action by one or more of the parties to the contract).

### PAYMENTS ON CHANGE IN CONTROL

Compensation does not fail to qualify as performance-based compensation merely because the plan allows for payment on a termination following a change in control until a change in control occurs. The compensation will fail to qualify as performance-based after a change in control occurs.

## COMPANIES THAT BECOME PUBLIC COMPANIES

The following special rules apply to compensation paid by private companies that later become publicly held.

### NEWLY PUBLIC COMPANIES

Remuneration paid according to a compensation plan or agreement that exists during a period that the corporation is not publicly held is excluded from the Section 162(m) limit. However, in the case of a corporation that becomes publicly held through an initial public offering (IPO), the exception for newly public companies applies only to the extent that the prospectus accompanying the IPO discloses information concerning those plans or agreements that satisfies all applicable securities laws then in effect.

This exception may be relied on until the earliest of:

- The plan or agreement expiring or being materially modified.
- All employer stock or other compensation that has been allocated under the plan being issued.
- For privately held companies that become public with an IPO, the first annual shareholder meeting at which directors are to be elected that occurs after the close of the third calendar year following the calendar year that the IPO occurs.
- For privately held companies that become public without an IPO, the first annual shareholder meeting at which directors are to be elected that occurs after the close of the first calendar year following the calendar year that the corporation becomes publicly held.

Compensation received under stock options, SARs or restricted stock is covered by this rule if the option, SAR or restricted stock was granted before the end of the transition period, regardless of when it is exercised or vests, as applicable. The Proposed Regulations provide that this exception does not apply to other forms of equity compensation, such as RSUs or phantom stock. Therefore, subject to finalization of the Proposed Regulations, it should be assumed that RSUs and phantom stock granted during the transition period will be excluded from the Section 162(m) limit only if they are paid before the transition period expires.

### SUBSIDIARIES THAT BECOME PUBLIC

Special transition rules apply for subsidiaries of public companies that become separate publicly held companies (whether by spin-off or otherwise). Generally, the compensation arrangements must:

- Meet the requirements for establishing performance goals.
- Satisfy the shareholder approval requirements.
- Be approved by outside directors of the old company before the spin-off.
- The compensation committee at the new company must certify that the goals were achieved.

Alternatively, the arrangements can be approved by the compensation committee of either the old or new company. In that case, the arrangement does not need to satisfy the shareholder approval requirement. However, the alternative is only available for compensation paid or equity awards granted before the new company's first annual meeting that occurs at least 12 months after the spin-off.

## LOWER DEDUCTION LIMITS FOR COMPANIES PARTICIPATING IN TARP AND HEALTH INSURANCE PROVIDERS

The Emergency Economic Stabilization Act of 2008 was enacted to allow the US federal government to purchase troubled assets from financial institutions under a program called the Troubled Asset Relief Program (TARP). Companies (such as banks, credit unions, security brokers and dealers and insurance companies) participating in TARP may not, among other things, deduct in excess of \$500,000 in compensation paid to a covered executive. TARP does not provide an exception for performance-based compensation or commission-based compensation. The \$500,000 limit applies to public and private corporations, as well as to partnerships. For more information on TARP, see *Practice Note, Government Bailout Programs* (<http://us.practicallaw.com/8-384-3367>).

The Patient Protection and Affordable Care Act (PPACA), the health care reform legislation enacted in March 2010, includes a similar deduction limit on compensation paid by health insurance providers. Under PPACA, neither a health insurance provider nor certain of its affiliates may deduct compensation paid to an individual in excess of \$500,000 per year. A health insurance provider generally includes any insurance company or similar organization that receives premiums for providing health insurance coverage. The deduction limit generally applies to all health insurance providers, regardless of whether they are publicly held corporations. However, IRS Notice 2011-2 includes a *de minimis* rule which exempts a health insurance provider if the premiums it receives, when aggregated with the premiums received by certain of its affiliates, are less than 2% of gross revenues annually.

The deduction limit does not only apply to compensation paid to covered employees; it applies to compensation paid to all individuals providing services to the health insurance provider or its applicable affiliates, including consultants and non-employee directors. In IRS Notice 2011-2, the IRS clarified that the deduction limit also applies to an independent contractor, unless the independent contractor provides substantial services to multiple unrelated customers. Similar to TARP, PPACA does not exclude from the deduction limit performance-based compensation or commission-based compensation. The deduction limit under PPACA generally applies to compensation earned and paid on or after January 1, 2013. However, the deduction limit under PPACA applies to compensation earned before January 1, 2013 if payment of the compensation is deferred until January 1, 2013 or later. For further information, see *Articles, Compensation Deduction Limit on Health Insurers May Have Broader Reach* (<http://us.practicallaw.com/6-502-4286>) and *Deduction Limit on Compensation Paid by Health Insurance Providers* (<http://us.practicallaw.com/1-502-8357>).

## COORDINATION BETWEEN SECTION 162(M) AND SECTION 409A OF THE IRC

Section 409A governs nonqualified deferred compensation arrangements. A payment that would otherwise qualify as a short-term deferral under Section 409A (see *Practice Note, Section 409A: Deferred Compensation Tax Rules: Overview: Short-term Deferral Exception* (<http://us.practicallaw.com/6-501-2009>)) that is made after the applicable 2½ month short-term deferral period may continue to qualify as a short-term deferral if the company establishes that:

- It reasonably anticipated that the deduction for the payment would not be permitted by Section 162(m) if the payment were made within the short-term deferral period.
- As of the date that the right to the payment arose, a reasonable person would not have anticipated the application of Section 162(m) at the time of the payment.
- The payment is made as soon as reasonably practicable after the first date that the company anticipates, or reasonably should anticipate, that if the payment were made on that date, the deduction would not be restricted due to Section 162(m).

## PAYMENTS SUBJECT TO SECTION 409A

A payment subject to Section 409A may be delayed to the extent that the company reasonably anticipates that if the payment were made as scheduled, the deduction would not be permitted due to Section 162(m), provided that the payment is made either during the:

- Officer's first taxable year that the company reasonably anticipates, or should reasonably anticipate, that if the payment is made during that year, the deduction will not be barred by Section 162(m).
- Period beginning with the date of the officer's separation from service and ending on the later of the:
  - last day of the taxable year of the company in which the officer separates from service; or
  - 15th day of the third month following the officer's separation from service.

All scheduled payments to the officer that can be delayed in accordance with this rule must be delayed.

Where the payment is delayed to a date on or after the officer's separation from service, the payment is considered a payment on a separation from service for purposes of Section 409A. Therefore, in the case of a specified employee, the payment must be delayed for six months (see *Practice Note, Specified Employees Under IRC Section 409A* (<http://us.practicallaw.com/7-501-1330>)). The company cannot provide the officer with an election concerning the timing of the delayed payment.

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