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Section 162(m) Revisited

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I. Introduction and Background

In the early 1990s, the investing community expressed mounting frustration over its belief that public companies were making excessive executive compensation payments without the approval or even knowledge of their shareholders. In response, in 1993 Congress enacted Internal Revenue Code[1] section 162(m), which caps a public company's corporate income tax deduction at $1 million per year for amounts paid to each of its top five executives.[2] However, the provision included an important exception for performance-based pay plans, provided the plans are preapproved by the company's shareholders and compensation committee.

Although many may have expected section 162(m)'s $1 million compensation limit to become a significant revenue raiser for the government, the provision has rarely resulted in nondeductible compensation for the well-prepared company. That is because section 162(m) is very narrow in its denial of executive compensation deductions, for three principal reasons. First, the provision applies only to public companies. Second, the $1 million cap applies only to a company's chief executive officer and each of the next four highest-paid executive officers (referred to as "covered employees"). Finally, and most important, the $1 million cap does not apply to performance-based pay (that is, bonuses).

Until recently, the provision had received little attention. Companies were able to structure plans that they believed met the performance exception, and the IRS applied a relaxed approach to reviewing executive compensation matters in corporate tax return examinations. However, last February the IRS announced ambitious plans to scrutinize executive compensation tax compliance, including compliance with the section 162(m) rules. In light of that renewed focus, this article will review the specific rules and exceptions under section 162(m), discuss developments and guidance in the 11 years since its enactment, and provide recommendations to ensure maximum deductions for executive compensation.

II. Definitions

Section 162(m) provides that for any publicly held corporation, no deduction shall be allowed for applicable employee remuneration regarding any covered employee to the extent that the amount of that remuneration to that employee for the tax year exceeds $1 million.

A. **Publicly Held Corporation**

Section 162(m) applies only to compensation paid by "publicly held corporations," which includes any corporation issuing any class of common equity securities required to be registered under section 12 of the Securities Exchange Act of 1934 (Exchange Act). Generally, registration is required if (1) the securities are listed on a national securities exchange such as the NYSE or the NASDAQ, or (2) the corporation has $5 million or more of assets and 500 or more holders of those securities. The determination is made solely on the last day of the taxpayer's tax year, including short periods. A careful review of the facts may be necessary to determine whether a corporation is publicly held for a given year. Consider, for example, the situation in which a management-led buyout on October 31 causes a calendar-year public company's stock to no longer be registered (under section 12 of the Exchange Act) as of that date. If the buyout triggers a short-period tax return -- for example, if the company is merged into a new company

[1] Internal Revenue Code of 1986, as amended.
[2] Omnibus Budget Reconciliation Act of 1993, P.L. 103-66.

or lifted out of a consolidated group -- the company will be considered a publicly held corporation for the short year ended October 31 but a nonpublicly held corporation for the short year ended December 31. Or if the buyout does not result in a short-period tax return (through October 31), the company will be considered a nonpublicly held corporation for the full year ended December 31.

A corporation that is a member of an affiliated group that includes a publicly held corporation is considered publicly held.[3]

Finally, note that a company that voluntarily registers its securities will generally not be considered a publicly held corporation.[4] However, there is no guidance defining the term "voluntarily." It is unclear whether a company that voluntarily but irrevocably registers its securities would be deemed a publicly held corporation.

B. Covered Employee

Section 162(m) limits deductions for compensation paid to so-called covered employees, which include the taxpayer's CEO and the next four highest-paid officers reported in the company's annual proxy statement.

1. Chief executive officer. For these purposes, the employee must be the named CEO or "an individual acting in such a capacity.[5]" Further, a CEO is a covered employee if he or she is acting in that role as of the close of the employer's tax year.[6]

2. Next four highest-paid officers. In addition to the CEO, the next four highest-paid officers, whose compensation for the tax year must be reported to shareholders under Exchange Act, are also covered employees.

3. Employed on last day of year. The regulations further narrow the requirement by providing that an officer is a covered employee only if he or she is employed as of the last day of the employer's tax year[7]. In letter rulings, the IRS National Office has addressed the requirement that, to be a covered employee, an executive must be employed as an executive officer on the last day of the tax year. For example, in LTR 199928014, Doc 1999-24174, 1999 TNT 137-19, the National Office concluded that corporate officers who resign their positions as employees and corporate officers before the last day of the tax year will not be considered covered employees for that year, even if they may continue to (1) be listed in the proxy under the SEC executive compensation disclosure rules, (2) perform services as independent consultants and directors, and (3) receive compensation from deferred bonuses, stock options, and annual income from consulting contracts.[8] The National Office added, however, that to not be considered a covered employee under the facts outlined above, the former executives must not intend to resume their duties as officers anytime in the foreseeable future. Thus, section 162(m) should not limit the deductibility of compensation paid to executives during their final year of employment, if they end employment before the last day of the employer's tax year.

4. SEC disclosure requirement. IRS guidance had made clear that an executive officer will not be treated as a covered employee unless he or

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[3] Treas. reg. section 1.162-27(c)(1)(ii).
[4] Treas. reg. section 1.162-27.
[5] Section 162(m)(3)(A).
[6] Section 162(m)(3)(A).
[7] Treas. reg. section 1.162-27(c)(2)(i).
[8] *See also* LTR 200152003, *Doc 2002-3, 2002 TNT 1-11.*

she is included in the employer's SEC summary compensation table[9] (the table found in a company's proxy). For example, the IRS concluded that executive officers of a U.S. corporation were not covered employees when the U.S. corporation's publicly held foreign corporate parent filed as a "foreign private issuer" with the SEC because the related SEC filing did not require the inclusion of a summary compensation table.[10] The IRS reached a similar conclusion even when American Depository Shares of the foreign parent's stock were traded on a U.S. exchange.[11] Again, the IRS's determination to exclude executives as covered employees was based on the fact that their compensation was never included in any summary compensation table described in Item 402(b) of Regulation S-K under the Exchange Act.

The requirement that compensation be disclosed to the SEC also applies to acquisitions. Thus, the compensation paid to officers of a public target was not limited under section 162(m) in the year the target was acquired by a public acquirer because no summary compensation table had to be filed by the target with the SEC in the year of the acquisition, and those officers would not be listed on any such tables of the acquirer for that year.[12]

C. Compensation Paid

Section 162(m) refers to compensation as "application employee remuneration" and defines the amount as "the aggregate amount allowable as a deduction . . . for such taxable year for remuneration for services performed by such employee."[13] That includes payments of wages, bonuses, fringe benefits, income from the exercise of stock options, and the value of any property received in any medium other than cash.

Compensation is evaluated under section 162(m) in the year it's allowed as a deduction to the employer, regardless of the year the services are performed by the employee. Thus, employer deductions from employee stock options are considered in the year the options are exercised rather than the year they are granted. Further, deferred compensation is generally considered in the year it's paid to the executive rather than the year it's earned or vested. That leads to a popular planning technique, which is to defer payment of compensation until a year in which the executive is no longer employed on the last day of the year (that is, the year of retirement), thereby excluding that compensation from the section 162(m) deduction limits.[14]

However, at the heart of section 162(m) are three significant types of compensation that are excluded from the definition of applicable employee remuneration:

- excluded fringe benefits;
- commissions; and
- performance-based pay.

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[9] Item 402(b) of Regulation S-K, Securities Exchange Act of 1934.

[10] LTRs 200129016, *Doc 2001-19626, 2001 TNT 141-13*, and 200115036, *Doc 2001-10716, 2001 TNT 73-35*.

[11] LTR 200021050, *Doc 2000-14960, 2000 TNT 104-17*.

[12] LTRs 200216001, *Doc 2002-9491, 2002 TNT 77-23;* 200219015, *Doc 2002-11415, 2002 TNT 92-61*; and 200419013, *Doc 2004-9803, 2004 TNT 90-52*.

[13] Section 162(m)(4)(A).

[14] The American Jobs Creation Act of 2004 restricted the use of deferred compensation plans. Additional care will be required in deferred compensation plans as vehicles to manage the effects of section 162(m).

1. Excluded fringe benefits. The section 162(m) limits do not apply to some tax-qualified fringe benefits that are excluded from the executive's taxable income.[15] Specifically, any payment made to or for the benefit of an officer into a tax-qualified retirement plan is not subject to section 162(m), as are payments that are excludable from the executive's gross income, such as employer-provided health insurance and group term insurance.

2. Commissions. The section 162(m) limits do not apply to some commissions -- specifically, amounts paid solely on account of income generated directly by the individual performance of the executive to receiving that compensation.[16] Congress tried to define the scope of that exception in the conference agreement, which explained that compensation that equals a percentage of sales made by the executive would qualify for the exception. The conference agreement added that the remuneration does not fail to be attributable directly to the executive merely because the executive uses support services, such as secretarial or research services, in generating the income. However, if compensation is paid on account of broader performance standards, such as income produced by a business unit of the corporation, the compensation would not qualify for the exception because it is not paid regarding income that is directly attributable to the individual executive.[17]

3. Performance-based compensation. The most significant and complex exception to the section 162(m) limits is the one for performance-based compensation. Employer tax deductions arising from executive bonuses and stock options exercises will be excluded from the $1 million limit if they are paid under a "performance-based plan."

In general, compensation qualifies as being from a performance-based plan only if it satisfies each of the following four requirements:

- It is paid solely because of the attainment of one or more preestablished and objective performance goals;
- The preestablished performance goal or goals used to determine the awards are established by a compensation committee consisting solely of two or more "outside directors";
- The material terms of the performance goal or goals under which compensation is paid are disclosed and later approved by the shareholders before compensating the executive; and
- The compensation committee certifies that the performance goals and other material terms were satisfied before paying the executive.[18]

a. Preestablished objective performance goals. For section 162(m) purposes, a performance goal is considered preestablished when the goal is established in writing by the compensation committee no later than 90 days after the commencement of the period of service to which the goal relates and while the achievement of the performance goal is substantially uncertain. If the goal relates to any other period of service, the goal will be viewed as substantially uncertain when less than 25 percent of the performance period covered by the goal has elapsed.[19] Thus, calendar-year bonus plans generally must be fully

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[15] Section 162(m)(4)(E).
[16] Section 162(m)(4)(B).
[17] Conference agreement. *See also* Treas. reg. section 1.162-27(d).
[18] Section 162(m)(4)(C).
[19] Treas. reg. section 1.162-27(e)(2)(i).

established before the end of March. If the 90-day period is missed, the "preestablished" requirement can be satisfied by moving the bonus period forward to come back within the 90-day window.

To meet the "objective" test, the performance goal or goals must be stated in terms of an objective formula or standard. A formula or standard is viewed as objective if a third party could calculate the amount of the award with knowledge of both the formula and the company's actual performance for the period.[20] The terms of an objective formula must preclude discretion to increase the amount of compensation that would otherwise be due on achievement of the goal. The ability to exercise discretion to reduce or even eliminate compensation on the attainment of a goal is permitted, unless the "negative" discretion acts to increase the amount payable to another employee.[21] For example, a bonus plan covering a company's top five executives that permits the compensation committee to award each executive up to 25 percent of the total bonus pool would not satisfy the "objective formula" because negative discretion might be required. In that case, the company could satisfy the objective-formula requirement by increasing the bonus pool amount by 25 percent and reducing the maximum percentage of the pool that could be awarded to any given executive to 20 percent.

The term "substantially uncertain" for purposes of goal setting will depend on each company's circumstances. However, the IRS has stated that if the goal is based on a company's achievement of net earnings, the target is deemed performance-based even though a company always achieves net earnings.

b. Compensation committee must include two outside directors. For a member of the compensation committee to be considered an outside director under section 162(m), the following four conditions must be met:

- the director must not be a current employee of the corporation;
- the director must not be a former employee of the corporation who is receiving compensation for prior services;
- the director must not be, nor have been, an officer of the corporation; and
- the director must not have received remuneration from the company for reasons other than being a director of the company.

A director will not qualify as an outside director if the director was an officer of a company that is currently affiliated with the company. However, if the director was an officer of a formerly affiliated company and not an officer of a currently affiliated company, the director would qualify as an outside director under section 162(m).

A director is not deemed to have received compensation from the company for reasons other than being a director when the additional compensation is viewed as de minimis. Additional compensation will qualify as de minimis when the amounts paid to an entity in which the director has a beneficial interest of 5 percent, but not more than 50 percent, do not exceed the lesser of $60,000 or 5 percent of the entity's gross revenue for the applicable tax year.

c. Disclosure and approval by shareholders. As stated above, the material terms of the performance goal must be disclosed to and approved by the company's shareholders before making any payments to the

[20] Treas. reg. section 1.162-27(e)(2)(ii).
[21] Treas. reg. section 1.162-27(e)(2)(iii).

executives. Material terms include: (1) a general description of the employees eligible for awards under the compensation program; (2) a description of the business criteria underlying each of the performance goals; and (3) either the maximum amount of compensation to be paid under the compensation plan or the formula used to calculate the compensation to be paid.

The material terms of the performance goal need not be disclosed to and approved by the shareholders again, unless the company makes changes that affect the material terms of the performance goal. However, if the compensation committee retains the discretion to change the targets for a given performance goal, the material terms of the performance goal must be disclosed to and reapproved by the shareholders at least once every five years.

In practice, many companies use performance plans that take into account several financial metrics, which may be applied differently from year to year. For that reason, it is difficult to disclose to shareholders the basis for a prospective year's performance formula. It is common for those companies to seek approval by disclosing the general performance targets that will be used and disclosing the maximum dollar payment that will be made to the covered employees over the performance period.

Once a performance-based plan has been submitted to and approved by shareholders, it generally needn't be resubmitted for reapproval after a merger or reorganization.[22]

Finally, it should be noted that compensation will not qualify for the performance-based exception if the executive has a right to receive the compensation despite the shareholders' failure to approve the compensation.[23] For example, assume a company hires an executive who enters into an employment agreement that includes a bonus plan that otherwise satisfies the requirements of the performance-based compensation exception. If the employment agreement fails to provide that the bonus plan is contingent on approval by a vote of the shareholders, amounts paid under the bonus plan will fail to qualify for the exception, even if the shareholders later approve the plan.

d. Compensation committee certification. Finally, before paying the executive, the compensation committee must certify in writing that the performance criteria and other material terms of the performance goal have been met.[24] Certification is not required if the compensation relates solely to an increase in the employer's stock price (that is, stock options and stock appreciation rights).

4. Special rule for stock options and stock appreciation rights. The performance-based plan rules are applied differently for awards of stock options and stock appreciation rights (SARs). Under the special rule, grants of stock options will qualify as performance-based compensation (and be excluded from the $1 million limit) if the following three conditions are met:

- the compensation committee must make the grant;
- the compensation program governing the award of stock options must state the maximum number of options that can be awarded to any employee during a stated time period; and

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[22] LTR 200104022, *Doc 2001-2602, 2001 TNT 19-16.*
[23] Conference agreement.
[24] Treas. reg. section 1.162-27(e)(5).

- the exercise price of the stock option must be at least equal to the stock's fair market value at the time of the option grant.[25]

It is critical to note that failure to fully satisfy those requirements will cause the options or SARs to fail to qualify as performance-based compensation. For example, assume a stock option is granted with an exercise price of $99 while the underlying stock is trading at $100. None of the ultimate tax deduction related to the stock option exercise will qualify for the performance-based compensation exception.

Also note that grants of restricted stock are generally not performance-based because the executive may receive compensation even if the stock price decreases or stays the same. Thus, the grant of restricted stock generally does not qualify for the performance-based compensation exception. However, restricted stock may qualify for the exception if the grant or vesting date is based on attainment of a performance goal rather than mere passage of time. For many companies that use restricted stock, the stock is granted as a part of an approved annual performance plan, with additional time vesting of the shares on award.

III. Exception for Newly Public Companies

The $1 million deduction limit will not apply to some amounts paid by a company that was not a publicly held corporation and then becomes a publicly held corporation.[26] The amounts that can be excluded from the $1 million limit under this important exception include amounts paid under a compensation plan or agreement when:

- the plan or agreement existed during the period in which the corporation was not publicly traded; and
- relevant information about the plan or agreement is disclosed in the prospectus accompanying the initial public offering.[27]

Newly public companies can rely on this exception until the earliest of the following events:

- expiration of the plan or agreement;
- material modification of the plan or agreement;
- issuance of all employer stock and other compensation allocated under the plan or agreement; or
- the first shareholder meeting at which directors are elected that occurs after the close of the third calendar year following the calendar year in which the IPO occurs. Assuming an IPO in 2004, this would occur in 2008.[28]

For stock options, the rules provide that the favorable exception will apply to any deduction arising from an executive's exercise of a stock option granted under a plan that was in place at the time of the IPO and properly disclosed in the IPO prospectus if the grant of those

[25] Treas. reg. section 1.162-27(e)(2)(vi).
[26] Treas. reg. section 1.162-27(f)(1).
[27] Treas. reg. section 1.162-27(f)(1).
[28] Treas. reg. section 1.162-27(f)(2).

options occurred no later than or before the earliest of the events listed above.[29]

Therefore, if all employment, bonus, and stock option plans are fully in effect at the time of the IPO and the terms of those arrangements are fully disclosed in the prospectus, amounts paid in the future should generally become exempt from the $1 million executive compensation limits.[30]

IV. Mergers and Acquisitions

Company executives often receive substantial compensation when their company is acquired. Those payments are commonly referred to as change-in-control or golden parachute payments. To the extent those payments are determined to be excessive under the code, a corporate tax deduction is disallowed for the excess parachute payments, and the recipient is even subject to a 20 percent excise tax.[31]

Section 162(m) provides that the $1 million cap shall be reduced dollar for dollar by the amount of any excess parachute payments, but not below zero. For example, if the CEO of a target received $3 million on her company being acquired, of which $600,000 was determined to be excess parachute payments under section 280G, then the section 162(m) limit for the CEO for the tax year would be reduced to $400,000 ($1 million - $600,000). Further, the $2.4 million otherwise deductible change-in-control payment would be subject to the reduced section 162(m) limitation of $600,000.

In practice, however, the provision that reduces the $1 million for excess parachute payments is seldom relevant. That is because the target's executives' pay during a change of control is rarely reported in a proxy statement, because the target typically goes out of existence on completion of the merger. Thus, the target's executives generally don't meet the definition of covered employees for the year of the acquisition. Their pay, including change-in-control payments, is not subject to the limitations under section 162(m).

V. IRS Section 162(m) Examination Initiative

Over the past year, the IRS initiated, on a pilot basis, an examination of executive compensation matters at 24 major U.S. corporate taxpayers. One of the areas of focus has been section 162(m) compliance, and two compliance issues in particular. Most important, the IRS is examining whether amounts purported to be fully deductible as performance-based compensation actually satisfy the exception's many strict requirements as outlined above. Second, the IRS wants to identify miscellaneous compensation that may be paid in excess of $1 million and should be nondeductible under section 162(m). For example, if an executive earns $1 million in base compensation, but is also given a company car and personal use of corporate aircraft, the IRS believes the total corporate costs in excess of $1 million should be nondeductible.

During the pilot executive compensation exam process, the IRS apparently identified several situations in which taxpayers have allegedly failed to properly limit compensation under section 162(m). According to the IRS, the most frequently occurring situation is when taxpayers have incorrectly claimed that compensation related to executive bonuses and stock options was excluded from the section 162(m) limit as performance-based compensation. As a result, the IRS recently

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[29] Treas. reg. section 1.162-27(f)(3).
[30] *See* LTR 200449012, *Doc 2004-22962*, *2004 TNT 234-25*, for a recent example of the application of section 162(m) in the context of an IPO.
[31] Sections 280G and 4999.

expanded its pilot study so that all IRS audits of all public companies will now include a review of executive compensation, including 162(m) compliance. The IRS has developed a standard IDR for agents to issue as part of their executive compensation examinations. All taxpayers that are publicly held should expect the IRS to scrutinize the application of section 162(m) to their executive compensation arrangements.

VI. Conclusion

Although Congress limited the deduction for some executive pay of public companies, it provided several exceptions, most notably for some incentive pay arrangements. However, qualifying for the exceptions often requires satisfying strict objective and mechanical requirements. The recent IRS pilot review of executive compensation indicated that many public companies are failing to comply with those strict requirements and are being forced to limit their deductions for compensation that could have been fully deducted. In light of this new focus by the IRS, all public companies should review their executive compensation arrangements, compensation committee procedures, and shareholder preapproval procedures to ensure that incentive payments are excluded from the $1 million deduction limits.

Daniel Nelson is a partner with PricewaterhouseCoopers LLP, Baltimore. He would like to acknowledge the assistance of Bill Dunn, partner, PricewaterhouseCoopers LLP. The information presented in this article is intended for general informational purposes and does not constitute the provision of legal or tax advice. The views set forth herein are the personal views of the author and do not necessarily reflect the views of PricewaterhouseCoopers LLP.