

## Section 162(m) Compliance

**L**ATE LAST YEAR, THE IRS ANNOUNCED A PILOT AUDIT INITIATIVE FOCUSED ON EXECUTIVE COMPENSATION. Among other things, the audit initiative focuses on compliance with the Section 162(m) deduction limit. Section 162(m) limits the corporate tax deduction for non-“performance-based” compensation paid to top executives of publicly-held corporations (“covered employees”) to no more than \$1,000,000 per executive per year.

After completing its initial round of audits, the IRS is expected to expand the audit initiative. As a result, public companies should consider conducting a self-assessment to identify potential violations of Section 162(m) in advance of an audit.

The following is a brief overview of Section 162(m):

### Certain Officers of Publicly Held Corporations

- Section 162(m) only applies to publicly-held companies (PHCs), defined generally to mean companies with publicly-traded securities.
- Section 162(m) only applies to compensation paid to persons who, as of the last day of the PHC’s taxable year, were either the CEO or among the other four most highly compensated officers of the PHC.
- All members of an affiliated group are treated as a single employer, so remuneration paid to a covered employee from all members of the affiliated group must be counted.
- Special transition rules apply to companies that become or cease to become PHCs, including by way of spin-off.

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**A relevant guide  
to help you determine  
your Compensation  
Committee’s  
compliance with  
Section 162(m)**

### Excluded Payments

Certain types of compensation are not subject to the deduction limit and are not taken into account in determining whether total compensation exceeds \$1,000,000, specifically:

- Remuneration paid on a commission basis;
- Performance-based compensation (discussed below);
- Payments to (and from) a tax-qualified retirement plan;
- Certain fringe benefits.

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### Performance-Based Compensation

The Section 162(m) limit does not apply to performance-based compensation. For purposes of qualifying compensation as “performance-based,” different rules apply to (1) stock options and stock appreciation rights (SARs); and (2) other forms of compensation, such as bonuses.

### Options and SARs

Compensation attributable to stock options and SARs will qualify as “performance-based,” and therefore not subject to the deduction limitation of Section 162(m) if the following requirements are met:

- **Option/SAR Price** – The price of the option or SAR (i.e., the exercise price) is not less than the fair market value of the underlying shares at the time of grant.
- **Compensation Committee** – The option or SAR grant is authorized by a compensation committee comprised solely of two or more “outside directors.”
- **Share Limit** – The plan under which the option or SAR is granted states the maximum number of shares with respect to which options or SARs may be granted during a specified period (e.g., a fiscal year) to any employee.
- **Shareholder Approval/Disclosure** – Shareholders approve, in a separate vote, the specific terms of the plan, who is eligible under the plan, the share limit, and any other material plan provisions.

### Other Compensation

Compensation other than compensation attributable to stock options or SARs qualifies as “performance-based” only if the four requirements described below are satisfied. For this purpose, other compensation includes bonuses and other forms of cash-based incentive pay, restricted stock, and options that are granted with an exercise price that is less than the fair market value of the stock at the time of grant (i.e., discount options). The four requirements are:

- **Performance Goals** – The compensation must be paid solely on account of attainment of one or more pre-established, objective performance goals.
- **Compensation Committee** – The performance goals must be established by a compensation committee comprised solely of two or more “outside directors.”
- **Shareholder Approval** – The material terms under which the compensation is to be paid, including the performance goals, must be disclosed to and approved by the shareholders in a separate vote prior to payment.

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- **Certification** – Prior to payment, the compensation committee must certify that the performance goals and any other material terms were in fact satisfied.

### Section 162(m) Compliance Checklist

The following checklist is designed to flag the most common areas of non-compliance. Note that since many aspects of Section 162(m) compliance hinge on the factual peculiarities of each public company, inquiry beyond the levels identified by the checklist may be warranted.

#### Performance-Based Compensation – Options and SARs

- Were the options/SARs granted under a plan that was approved by shareholders in a separate vote?
- Has the plan been materially amended without a shareholder vote, such as an increase to the grant limit?
- In the case of a plan in existence before the company's IPO, was the plan approved on or before the first shareholder meeting after the close of the third calendar year after the calendar year in which the IPO occurs?
- Were the options/SARs granted by a compensation committee consisting solely of two or more "outside directors" (described below)?
- Does the plan include a limit on the maximum number of shares with respect to which options/SARs may be granted during a specified period to any employee?
- Were option/SAR grants made in excess of plan limits?
- Were options/SARs granted with exercise prices less than fair market value on the grant date?

#### Performance-Based Compensation – Other Compensation

- Was the compensation paid pursuant to a plan that was approved by shareholders in a separate vote?
- Does the plan include a limit on the compensation that could be paid to any employee under the plan or a formula that can be used to calculate the maximum amount that can be paid?
- Has the plan been materially amended without a shareholder vote?

In the case of a plan in existence before the company's initial public offering (IPO), was the plan approved (or re-approved) on or before the first shareholder meet-

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ing after the close of the third calendar year following the calendar year in which the IPO occurs?

- If the compensation committee authority to use difference performance measures under the plan, has the plan been approved (or re-approved) by shareholders on or before the fifth year following the year of prior shareholder approval?
- Are the performance measures objective and tied to something other than employment?
- Are the performance goals substantially uncertain to occur at the time they are set?
- Were the performance measures established on a timely basis (e.g., within the first 25% of the performance period)?
- Does the plan preclude discretion to increase the amount of compensation that would otherwise be due upon attainment of the performance goal?
- If the payment date was accelerated, was the payment amount reduced to reflect the time value of money?
- Were the performance goals established by a compensation committee consisting solely of two or more “outside directors” (described below)?
- Did the compensation committee certify in writing, prior to payment, that the performance goals were satisfied?

### Outside Directors

- Is any member of the compensation committee a current employee of the PHC?
- Is any member of the compensation committee a former employee of the PHC who receives compensation for prior services (other than under a qualified retirement plan)?
- Is any member of the compensation committee a current or former officer of the PHC?
- Does any member of the compensation committee receive remuneration from the PHC, directly or indirectly, in any capacity other than as a director? (Note: certain de minimis remuneration is acceptable).

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## Common Section 162(m) Violations

- Options granted under a non-shareholder approved plan. For example, options may be granted to a new officer under an “inducement” plan that has not been approved by shareholders.
- Options granted under a plan in excess of the plan’s periodic (e.g., annual) grant limit.
- Bonus or other incentive payments (including option grants) made under a pre-IPO plan that was not timely approved (or re-approved) as required following the IPO.
- Restricted stock (or restricted stock units) or other full value awards, where neither the grant nor the vesting is tied to objective, pre-established performance criteria under a shareholder approved plan.
- Bonus or other incentive payments made under a plan that gives the compensation committee authority to change performance measures that was not re-approved by shareholders on or before the fifth year following the year of prior shareholder approval.
- Non-performance-based compensation exceeds \$1 million in a year. This may result where the officer’s base salary is high and (i) the bonus plan is not “performance-based,” (ii) there’s a restricted stock vesting event or a payout under a deferred compensation or restricted stock unit arrangement, or (iii) as a result of significant perquisites.
- The compensation committee changes the performance targets or otherwise exercises impermissible discretion under the plan.
- The compensation committee includes someone who does not meet the technical requirements to be an “outside director.”
- Discretionary authority (e.g., option grants) is exercised other than by a qualifying compensation committee (by the full Board, for example).
- The compensation committee fails to certify in writing prior to payment that the performance goals have been satisfied.
- The performance goals are not set soon enough – e.g., not set within the first 90 days of a one-year performance period. ♦

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