Inadvertent Section 162(m) Violations

Compensation Committees may not be aware that certain elements of their company's executive compensation program are not fully deductible. As a result, Compensation Committees may be making executive compensation decisions without taking the full cost of those decisions into account.

Section 162(m) of the Internal Revenue Code imposes a limit on the deductibility of compensation paid to top executives of public companies. The limit does not apply to compensation that qualifies as "performance-based" as defined in Section 162(m). Significantly, the limit does not apply to compensation attributable to most employee stock options.

In anticipation of Section 162(m), which took effect on January 1, 1994, most companies thoroughly reviewed their compensation programs to assess the impact of Section 162(m). Many companies concluded that the limit did not apply to them since their executive pay consisted of cash compensation that was below the limit and stock options. Other companies took steps to mitigate the impact of Section 162(m) by, among other things, structuring compensation programs to qualify as "performance based."

Since 1994, cash compensation at public companies has increased significantly and many companies have begun to expand their long-term incentive programs beyond traditional stock options. In addition, compensation programs that were initially structured to qualify as "performance-based" may no longer qualify. As a result, companies may be paying compensation that is non-deductible under Section 162(m). Compensation Committees may not be aware of this additional cost. Worse yet, companies may be taking tax deductions in violation of Section 162(m).

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There are several common patterns that can lead to inadvertent non-deductibility under Section 162(m). The sheer increase in cash compensation over the past 10 years can result in compensation that exceeds the $1,000,000 per year deduction limit. Or, companies with bonus plans tied to objective, financial performance metrics may mistakenly believe that the plan meets the technical requirements of Section 162(m). Other companies that qualified their bonus plans when Section 162(m) first took effect may have forfeited that qualification by failing to renew shareholder approval of the plan or otherwise violating the requirements of Section 162(m). This could occur, for example, where the plan gives the Compensation Committee wide latitude in picking the financial metrics to be used in determining bonus payouts. Under the Section 162(m) regulations, such a plan must be

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re-approved by the shareholders every five years. Qualification might also be lost if a plan has been materially amended without shareholder approval.

Companies that have begun to grant full value shares (restricted stock, restricted stock units) may also discover that the tax deduction associated with those grants is limited. Unless the grant or vesting of those awards fits the technical requirements of "performance-based" under Section 162(m), such amounts would be subject to the deduction limit. This could occur, for example, where the company grants restricted stock that vests based on continued employment, even if the grant includes accelerated vesting tied to performance.

Compensation Committees need to understand the Section 162(m) consequences of each element of the company's executive pay program to fully understand the program's true cost. Moreover, Committees should ensure that the company's policy with regard to Section 162(m), as reflected in the proxy, accurately and thoroughly addresses each element of the company's executive pay program. Finally, as part of its internal controls, companies should include an examination of tax deductibility under Section 162(m). ♦

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