Cooley LLP
Comp Talks
The Latest re Section 162(m)

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Topics to Be Covered

- IRC Section 162(m) Overview
- Latest IRS Guidance
- Common Pitfalls with Performance-Based Compensation
- Best Practices
- Meta Funding Plan Structure

IRC Section 162(m) Background

- Section 162(a): In general, a company may take as a tax deduction all the ordinary and necessary expenses incurred during the taxable year in carrying on a trade or business, including a reasonable allowance for salaries or other compensation
- Section 162(m): For publicly held companies, no tax deduction is allowed for certain compensation to any "covered employee" to the extent the compensation in that taxable year exceeds $1 million
  - Covered employees are defined as the CEO and the three highest paid officers (other than the CEO and CFO) as of the end of the completed fiscal year
- The $1 million limit applies to the aggregate of the employee's annual compensation
  - Salary, sign-on bonuses, annual and long-term incentives, equity grants and housing allowances are examples of compensation subject to 162(m)

Section 162(m) Excluded Compensation

- Certain types of compensation are excluded from the $1 million limit
  - 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
  - Qualified performance-based compensation
    - Includes most performance-based equity grants made under a shareholder approved plan

IPO Exception for Newly Public Companies

- Under the IPO exception, the $1 million limit does not apply to any compensation “paid” pursuant to a plan or agreement that existed during the period in which a company was not publicly held, until the earliest of:
  - The expiration or material modification of the plan or agreement
  - The issuance of all stock or other compensation allocated under the plan or agreement
  - The first annual shareholders 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
    - For example, if a company completes its IPO in 2015, the transition period would end on the annual shareholders meeting in 2019

Year	2015	2016	2017	2018	2019
Event	IPO				2019 Shareholders Meeting Transition Period Expires

Qualified Performance-Based Compensation

- To qualify for the qualified performance-based compensation exception, compensation must meet the following requirements:
  - **Performance Goals.** The compensation must be contingent solely on the attainment of one or more “pre-established,” objective performance goals
    - Attainment must be substantially uncertain at time goals are established
  - **Compensation committee.** The performance goals must be set by the corporation’s compensation committee
  - **Shareholder approval.** Before payment, shareholders in a separate vote must approve the material terms of the compensation, including the applicable performance goals and the maximum amount payable to any covered employee

Qualified Performance-Based Compensation

- **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
  - Special rule for options and stock appreciation rights (SARs)
    - Qualify as performance-based compensation if approved by qualifying compensation committee, granted under shareholder approved plan and have FMV exercise price
    - Performance-based vesting not required
- **Precludes upward discretion.**
  - Cannot provide that performance goals are satisfied if not clearly met
  - Cannot provide for additional payments if performance goals are exceeded

Section 162(m) Updates

- IRS issued final regulations in 2015 that confirm that in order for stock options or SARs to qualify for the performance-based compensation exception, the plans under which such awards are granted must state the maximum number of shares that may be granted pursuant to such awards during a specified period <u>to any individual employee</u>
    - This means that an overall plan limit on the aggregate number of shares that may be granted under the plan is not sufficient
- The final regulations also clarify that restricted stock units (RSUs) or phantom stock arrangements would only qualify for the IPO exception if they are settled or paid before the end of the transition period
- The final regulations provide relief for companies that recently became public by making this clarification concerning RSUs and phantom stock arrangements only apply to equity-based awards granted <u>on or after April 1, 2015</u>

Common Section 162(m) Pitfalls

- Failure to have plan timely reapproved by shareholders
  - The material terms of the plan must generally be reapproved by the company's shareholders every five years
- Failure to timely establish performance goals within 90 days of beginning of period (or before 25% of period has elapsed), or making changes to goals after such period
- Exceeding the annual per person limit for stock option award to a new officer
- Not using shareholder approved performance goals set forth in plan
- Disqualification of compensation committee member as an "outside director" based on interim CEO service, or professional service relationship between Board member's firm (e.g., accounting, law) and the company

Common Section 162(m) Pitfalls

- Paying compensation when performance goals have not been attained
- Increasing the amount of compensation otherwise due on achievement of pre-established performance goal
- Full board approving CEO compensation
- Delegation to CEO of authority to determine bonuses or equity awards for other executive officers
- Guaranteed payment of award as severance upon termination of employment without cause or for good reason
- Inducement grants – do not qualify as performance-based compensation

Best Practices for Performance-Based Compensation

- Include the ability to grant cash awards that can qualify as performance-based compensation in the company's omnibus equity incentive plan
    - Company will only have to submit one plan for shareholder approval
- Plan should provide that compensation committee may select performance goals from pre-approved performance criteria annually, and include the ability to adjust the methods that can be used to calculate performance targets in the plan
    - Will require re-approval of the plan by shareholders every five years
- Ensure that compensation committee charter does not provide that compensation paid to CEO is recommended to and approved by the full board

Meta-Funding Plans

Question: Is there any way to award compensation that qualifies as performance-based compensation based in part on performance goals that are not pre-approved by the company's shareholders?

- Performance-based compensation may only be paid based upon the attainment of one or more objective performance goals that have been pre-approved by the company's shareholders
- Could structure plan to be funded at a multiple of target bonuses for all participants in the plan, based upon achievement of one or more performance goals set forth in the shareholder-approved plan
- Awards can then be adjusted downward based on one or more performance goals that the company wants to use to measure performance that are not set forth in the plan and were not approved by the shareholders, to reach the desired bonus amount
- While the use of discretion to increase an award to the extent the performance goals are exceeded does not meet the Section 162(m) performance-based compensation requirements, the use of discretion in this type of meta-funding plan to *reduce* an award is permitted under Section 162(m)

Meta-Funding Plan – Example

- Assume CEO and three executive officers have annual target performance bonuses of 100%, 60%, 50% and 50% of their base salaries respectively, with the sum of their target bonuses equaling $900,000
- The company wants to calculate bonuses based on both company-wide performance metrics as well as individual performance goals tailored to each executive, with each performance target weighted 20%
- Meta-funding plan would provide that an amount equal to 200% of participant target bonuses, or $1,800,000, would be funded into a bonus pool if one or more shareholder-approved performance goals are attained (such as attainment of a specified amount of net earnings or an EBITDA target)
- The awards at the 200% level for each participant could then be adjusted downward based upon achievement of individual or corporate level non-shareholder approved performance targets (e.g. sum of results of achieving each of 5 targets weighted 20% per target to reach target bonus)
    - As long as the bonus paid to each individual is less than 200% of the individual’s target bonus (the funded amount), the bonuses may qualify as performance-based compensation for purposes of Section 162(m)

Meta-Funding Plan Considerations

- Plan is “all or nothing” – no awards may be paid under plan if 162(m) shareholder approved target is not achieved
  - If awards are paid regardless of achievement of this performance metric, they will not qualify as performance-based compensation
- Funded bonus “pool” cannot be adjusted to change participant awards
  - Amount by which one participant’s award is reduced if the participant does not achieve all individual performance goals cannot be used to increase another participant’s award
- Bonuses can be paid based on stretch performance if individual goals are exceeded, as long as bonus paid does not exceed funded amount
- Plan can be complex and requires educating management team

QUESTIONS?