summary
Since the introduction of Section 162(m) in 1994, new of legislation has slowly chipped away at the exemptions allowable under the rule, the latest being the recently enacted PPACA and its effect on health insurance providers. As executive pay levels continue to be a controversial and populist issue, what will executive compensation look like if Congress decides to broaden those PPACA limits across the board, to all types of organizations?

quick look

- Under 162(m), a publicly held corporation is precluded from deducting compensation paid to a "covered employee" in excess of $1,000,000.
- Levels of executive compensation continue to be a controversial and populist issue and Congress likely will also be looking for ways to generate additional revenue.
- Certain components of compensation cannot qualify as performance-based.

Broad Deductibility Limitations

secondary head: Are Limits on Compensation in Pursuit of All Companies?

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The recently enacted Patient Protection and Affordable Care Act (PPACA) amended 162(m) of the Internal Revenue Code to limit the tax deduction of health insurance providers for compensation to $500,000. Upon reading the provisions, one is reminded of Tick Tock Croc in Peter Pan. The crocodile liked the taste of Captain Hook's hand so much he followed him around constantly, hoping for more. Fortunately, for Hook, the croc had also swallowed an alarm clock so he always knew when the croc was approaching. So are compensation professionals now hearing the tick tock of the clock?

Hungry for revenue, how likely is it that Congress will broadly legislate a $500,000 deductibility limitation like that contained in the health-care reform bill, a limitation that contains no exceptions for performance-based compensation, applies when compensation is earned rather than when it is otherwise deductible, encompasses public and private companies, and sweeps in anyone who provides services to the company? This article will discuss the new 162(m) limit contained in PPACA and how it has evolved from the limitation that is applicable to publicly traded companies and companies subject to the Troubled Assets Relief Program (TARP). We will also speculate how such a limitation, if applied to all companies, may impact executive compensation design.

In the Beginning

Section 162(m) has been with us since 1994. Under 162(m), a publicly held corporation is precluded from deducting compensation paid to a "covered employee" in excess of $1,000,000. A covered employee is the CEO and the three highest paid executive officers (as determined pursuant to the SEC's disclosure rules) on the last day of the taxable year. The CFO, whose compensation is required to be disclosed pursuant to the SEC's rules, is not a covered employee for purposes of Section 162(m).

Section 162(m) contains numerous exemptions; however, the one that is most widely used is the exemption for performance-based compensation. If the requirements to qualify compensation as performance-based are satisfied, the deductibility limitation does not apply. It is relatively easy to qualify compensation as performance-based with the result being that most companies retain the deductibility of the majority of the compensation paid to covered employees even if it is in excess of $1,000,000.

Chipping Away…Section 162(m) Amended for TARP Recipients
The Emergency Economic Stabilization Act of 2008 (EESA) amended 162(m) to impose additional restrictions on companies that sell assets to Treasury under TARP. Generally effective as of Feb. 17, 2009, 162(m)(5) applies for any tax year during which any obligation arising from the receipt of financial assistance under TARP is outstanding.

Under Section 162(m)(5), the deduction for executive compensation is limited to $500,000, and provides for the following:

- Eliminates exemptions for certain types of compensation, most importantly, the exemption for qualified performance-based compensation,
- Applies to all companies, public and private, (assets acquired must exceed $300M)
- Applies to compensation in the year in which it is otherwise deductible, except deferred compensation, in which case the limit applies when the compensation is earned, and
- Broadens covered executives to include the chief financial officer and once an individual is covered, he/she always remains a covered executive for all subsequent applicable tax years and for all years to which compensation earned during an applicable tax year is deferred

More Chipping Away…Section 162(m) Amended for Certain Health Insurance Providers
The PPACA went further to eliminate the perceived loopholes under Section 162(m). PPACA added Section 162(m)(6) to limit the deduction for compensation of certain public **and** private health insurance companies. New 162(m)(6) is effective for compensation paid in tax years beginning after 2012 with respect to services performed after 2009.

As with TARP companies, the deduction limit on compensation is $500,000 with **no** exemptions and the limit applies to compensation in the year in which it is otherwise deductible, except deferred compensation, in which case, the limit applies when the compensation is earned. However, 162(m)(6) covers **any** officer, director, employee, or **anyone else** who provides services.

What If…162(m) Limitations for Health Insurance Providers Apply More Broadly
It would not be surprising, if within the next few years, the provisions of 162(m)(6) are eventually applied to all companies. Levels of executive compensation continue to be a controversial and populist issue and Congress likely will also be looking for ways to generate additional revenue. So, if this were to happen, how might executive compensation practices change?

Renewed Interest in Incentive Stock Options (ISOs)
We may see an increased interest in ISOs. Because of the limitations imposed on their use by the Internal Revenue Code, the prevalence and popularity of ISOs has declined. The most significant limitations are the:

- $100,000 limit, which requires that no more than $100,000 in the aggregate fair market value of the stock (determined as of the date of grant) can become exercisable for the first time in any calendar year, and
- Inability of corporations to deduct the spread at exercise (i.e., there is no corporate tax deduction, provided the shares received upon exercise of the stock option are held for two years from the grant of the ISOs and one year after exercise, called the “holding period requirements”).

If a tax deduction were limited to $500,000 with no exception for performance-based compensation, there is likely to be a significant amount of nondeductible compensation related to gains on nonqualified stock options (NQSOs). Under current 162(m) rules, it is very easy to qualify NQSOs as performance-based compensation, and most companies do (thus retaining the tax deduction). However, if the gain becomes nondeductible, why not grant ISOs? As stated, the gain

on ISOs is already nondeductible if the holding period requirements are satisfied and thus, companies may be indifferent to granting ISOs or NQSOs assuming the $500,000 limit is "used" for other compensation, such as base salary and/or bonus payments.

Employees, on the other hand, would likely not be indifferent because of the tax advantages of ISOs (if the holding period requirements are satisfied). The first advantage is that the amount realized is taxed to the employee at more favorable long-term capital gains rates. The second advantage is that the taxable event is delayed from exercise to sale. These tax advantages may be offset if the individual is subject to the Alternative Minimum Tax, a discussion of which is complicated and beyond the scope of this article.

Note, however, that it is relatively common for employees to not satisfy the holding period requirements, called a "disqualifying disposition." The question is whether it remains advantageous for either the employer or the employee to grant ISOs instead of NQSOs. The answer is yes, because there is a payroll tax benefit to both employers and employees which is not applicable to NQSOs. Upon a disqualifying disposition, ISOs are not subject to FICA (which does apply to NQSOs and other forms of compensation). Neither the employer nor the employee would be liable for the FICA obligation. Not being subject to FICA could result in a significant savings for employers and employees.

Ability to Include an Evaluation of Individual Performance and/or Strategic Metrics and Increased Use of Discretion

One of the more challenging issues compensation committees face in qualifying compensation as performance-based is pre-establishing compensation formulas that are objective, and run on "automatic pilot", absent the exercise of negative discretion. As a result, many companies have adopted "umbrella" plans to satisfy the performance goal requirement. The umbrella plan establishes a compensation formula that generates a bonus pool that is generally larger than the amounts needed to fund the bonus payments. The plan underlying the umbrella plan is the plan that the compensation committee uses to determine the amounts that would actually be paid. Negative discretion is applied to the 162(m) umbrella plan to cut back the amounts to what the compensation committee would pay under the underlying plan.

Clearly, if the exception for performance-based compensation is eliminated, there would no longer be a reason to create umbrella plans. Compensation committees would likely identify at the beginning of the performance period the specific performance metrics and goals based on what they deem is appropriate to achieve the desired results. However, they would be permitted more flexibility to exercise discretion (positive and/or negative) to make adjustments based on their informed judgment of what has occurred throughout the performance period. Also, compensation committees would not be limited to goals that can be objectively measured and could subjectively evaluate individual performance or progress towards strategic objectives.

Keep in mind, that publicly-traded companies are required to discuss in their proxies in the Compensation Discussion & Analysis (CD&A), the rationale for their compensation decisions, and thus, to the extent discretion is exercised, that would need to be explained in the CD&A. If goals are subjective and companies can successfully argue that disclosure of the targets would result in competitive harm, companies may be able to avoid disclosure of the specific targets in their proxies. It is generally easier to make this argument with respect to subjective and/or strategic goals than it is for objective financial goals.

No Need for Shareholder Approval of Cash-Based Annual Bonus or Long-Term Incentive Plans

One of the current requirements to qualify compensation as performance-based is shareholder approval of the material terms. Although most investors and proxy advisory firms vote for (or recommend a vote for) compensation plans that are submitted to shareholders solely to satisfy the 162(m) requirements, there is always the possibility that a plan may not receive shareholder support, particularly if there is another issue that is of concern to shareholders. For example, Institutional Shareholder Services (ISS) generally recommends a vote for cash bonus plans that are submitted to shareholders for the purpose of complying with the requirements of Section 162(m). However, ISS will recommend a

vote against those proposals if the compensation committee does not fully consist of independent outsiders, as defined in ISS's classification of director independence.

Focus on Performance-based Compensation

At first glance, this may seem counter-intuitive. After all, 162(m) provides an incentive to companies to have performance-based compensation. Certain components of compensation, e.g., restricted stock or restricted stock units with vesting based solely on the passage of time or continued employment, cannot qualify as performance-based. If the performance-based exception is eliminated, it is logical to assume that companies may increase their usage of restricted stock or restricted stock units.

However, we think it is just as likely (or perhaps even more likely) that companies will increase their use of performance-based compensation for the following reasons:

- The use of positive discretion would not be proscribed, and companies would not be required to establish performance goals that operate on automatic pilot. There would be increased flexibility to base payments on actual performance, with consideration of discretionary (both up and down) adjustments.
- Shareholder activists and proxy advisory firms will continue to pressure companies to have a majority of their compensation be performance-based, and if is not, there may be other consequences (e.g., voting against a management say-on-pay proposal, voting against an equity compensation plan or withholding votes from compensation committee members).
- If compensation in excess of $500,000 is nondeductible, the "bang" should be worth the "buck", in other words, compensation in excess of $500,000 should be worth paying and generating a benefit that is in excess of the cost of the lost tax deduction.

Some Increased Interest in Performance-Accelerated Restricted Stock or Restricted Stock Units

There may be some interest in using performance-accelerated restricted stock or restricted stock units, awards that currently do not qualify as performance-based compensation under 162(m). Companies that want to have their restricted stock or restricted stock units be more performance-based, but are uncomfortable with their ability to set long-term goals, could establish plans that would vest ultimately based on continued employment but would pay out earlier if performance objectives are achieved. In the event the performance goals are not achieved, the employment requirement could be substantially longer so that payment is only made to employees who stay with the company for a significant period of time.

Increased Flexibility with Respect to Consequences Upon a Termination of Employment

Recent Revenue Ruling 2008-13 has had an impact on many compensation plans and has required many companies to amend their plans in order to be in compliance with the Ruling's requirements. Revenue Ruling 2008-13 clarified that amounts payable upon retirement or upon a termination without cause prior to the attainment of the performance goals cannot be performance-based. Thus, if a plan allows for payment upon these events, the entire plan is disqualified from being performance-based compensation, even if no payments upon these events are actually made. Prior to the issuance of the Revenue Ruling, it was not uncommon for companies to pay a pro-rata or full (at target or actual performance) bonus or long-term award upon retirement and sometimes upon a termination without cause. The payment was typically made when the termination event occurred. The result of the Ruling is that companies that had such a provision in their plans, needed to amend their plans, and to generally postpone payment until the end of the performance period and to base payment on actual performance (and not on target).

Conclusion

If Congress applies the amendments that are applicable to health insurance providers to a much broader group of companies, the impact on compensation programs could be significant. This article discusses some of the issues for consideration.

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