Section 162(m): Limit on Compensation

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This Note provides a summary of the $1 million deduction limitation on certain employee compensation imposed on publicly held companies by Section 162(m) of the Internal Revenue Code. This Note also addresses the exception from the $1 million deduction limitation for qualified performance-based compensation.

Publicly held corporations should consider the effects of Section 162(m) of the Internal Revenue Code (IRC):

- When negotiating executive compensation packages.
- During the corporate tax planning process.
- When establishing overall employee incentive programs designed to maximize shareholder value.

Section 162(m) prohibits publicly held corporations from deducting more than $1 million per year in compensation paid to each of certain covered employees (see *Covered Employees*). To assist publicly held corporations in preparing for the effects of Section 162(m), this Note explains the rules relating to Section 162(m), including the:

- Employees that are covered.
- Types of compensation that are subject to Section 162(m).
- Requirements that need to be met for certain types of compensation to be exempt from the deduction limit.
- Relationship between Section 162(m) and other tax rules that separately impact executive compensation.

COMPANIES SUBJECT TO SECTION 162(M)

Generally all corporations that are publicly held on the last day of their taxable year are subject to the $1 million deduction limit under Section 162(m).

A publicly held corporation is any corporation that issues any class of common equity securities required to be registered under Section 12 of the Securities Exchange Act of 1934, as amended (Exchange Act). A corporation is not considered publicly held if the registration of its equity securities is voluntary.

AFFILIATED GROUP OF CORPORATIONS

All members of an affiliated group of corporations are considered publicly held if any member of the group is publicly held. Any subsidiary that is itself a publicly held corporation, and any of its subsidiaries, are separately subject to Section 162(m).

PARTNERSHIPS

Several Internal Revenue Service (IRS) private letter rulings address how Section 162(m) applies to the compensation that a publicly held corporation's covered employees receive from a partnership in which the corporation has an ownership interest for services the employee performs for the partnership. The IRS ruled that the Section 162(m) deduction limitation does not apply to the:

- Partnership, for compensation it paid to the covered employee for services performed as an employee of the partnership.
- Corporation, for its distributive share of income or loss from the partnership that includes compensation expenses for services performed by the covered employee as an employee of the partnership.

(See *PLR 200837024*; *PLR 200727008*.)

SITUATIONS WHEN SECTION 162(M) DOES NOT APPLY

Section 162(m) does not apply to:

- Short tax years ending with mergers, where the acquired company is not required to comply with the Exchange Act's executive compensation disclosure rules for the short tax year.
- Foreign private issuers that are not subject to the Exchange Act executive compensation disclosure rules.

COVERED EMPLOYEES

Under Section 162(m), as interpreted by IRS Notice 2007-49, a covered employee is any individual who, on the last day of the taxable year, is:

- The principal/chief executive officer (PEO/CEO) (or an employee acting in that capacity) of the corporation.
- The three highest compensated officers (excluding the PEO/CEO and the principal/chief financial officer (PFO/CFO)) whose compensation is required to be reported to shareholders under the Securities and Exchange Commission's (SEC's) executive compensation disclosure rules.

Although certain covered employees are determined by looking to the SEC executive compensation disclosure rules, the definition of covered employee does not mirror the definition of named executive officer. For example, a company's PFO/CFO is a named executive officer by virtue of his position; however, IRS Notice 2007-49 clarifies that a company's PFO/CFO is not a covered employee under Section 162(m).

In a private letter ruling, the IRS held that an employee, who resigned as the corporation's president and CEO to become a senior advisor, was not a covered employee under Section 162(m) because the employee was not an executive officer on the last day of the tax year. However, even though the employee was not an executive officer on the last day of the tax year in question, the employee's compensation was required to be disclosed by the SEC executive compensation disclosure rules because the employee served as a CEO for a portion of the tax year (*PLR 200836010*).

The Jumpstart Our Business Startups Act (JOBS Act) was signed into law on April 5, 2012. Under Section 101 of the JOBS Act, an "emerging growth company" (EGC) generally means an issuer with total annual gross revenues of less than $1 billion during its most recently completed fiscal year. Under the executive compensation disclosure rules, an EGC may limit its disclosure to only the PEO/CEO and its two most highly compensated officers. While Section 162(m) provides a transition relief period for newly public companies (see *Companies that Become Public Companies)*, when Section 162(m) becomes applicable to an EGC, it is unclear whether the PFO/CFO is a covered employee for purposes of Section 162(m) (as the individual's disclosure in the proxy is not by reason of his status as PFO/CFO but by reason of his compensation).

COMPENSATION

Compensation for Section 162(m) purposes is the aggregate amount paid to the executive:

- For services performed as a covered employee.
- That is allowed as a deduction by the corporation for the taxable year (determined without regard to the $1 million limit imposed by Section 162(m)).
- Regardless of whether the services were performed during the taxable year.

The $1 million deduction limit is not reduced where an employer that is newly formed as a result of a spin-off has a short taxable year (*PLR 9810024*).

EXCLUDED COMPENSATION

For purposes of Section 162(m)'s deduction limitation, compensation does not include the following:

- 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 (see *Commission-based Compensation*).
- Qualified performance-based compensation (see *Qualified Performance-based Compensation*).

For example, the CEO of a publicly held corporation retired and then re-assumed his duties within the same tax year. While retired, he received certain payments from the corporation, which included payments:

- From a qualified plan.
- For non-employee consulting with the corporation.
- As a director of the corporation.

Because the pension payments were from a qualified plan, the IRS held that the payments were not subject to the Section 162(m) deduction limitation. In addition, because the other two payments were for services that were not performed as a covered employee, the IRS held that those payments were also not subject to the Section 162(m) deduction limitation.

COMMISSION-BASED COMPENSATION

The Section 162(m) limitation on deductible compensation does not apply to commission-based compensation generated directly by the individual (not a group or business unit).

However, in a private letter ruling, the IRS held that a bonus paid to an individual for that individual's contributions as part of a team that obtained a commission for the team's efforts qualified for the commission-based compensation exception (*PLR 200541033*).

QUALIFIED PERFORMANCE-BASED COMPENSATION

The Section 162(m) limit on deductible compensation also does not apply to compensation that is qualified performance-based compensation. The determination of whether compensation is performance-based is made on a grant-by-grant basis. To qualify for the performance-based compensation exception, payment of the compensation must meet the following requirements:

- **Performance goals.** The compensation must be contingent on the attainment of one or more "pre-established," objective performance goals (see *Performance Goals*).
- **Compensation committee.** The performance goals must be set by the corporation's compensation committee (see *Compensation Committee*).
- **Shareholder approval.** Before payment, shareholders in a separate vote must approve the compensation terms, including the applicable performance goals and the maximum amount payable to any covered employee (see *Shareholder Approval Requirements*).
- **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 (see *Certifying Achievement of Performance Goals*).

PERFORMANCE GOALS

To qualify for the exception, the performance goal must be:

- Established in writing before or soon after the performance period starts. The goal must be set within a grace period that expires on the earlier of:
  - 90 days after the beginning of the performance period (or, if earlier, when the outcome is no longer substantially uncertain); or
  - when 25% of the performance period has elapsed.
- Based on business criteria, which may apply to an individual, business unit, the corporation as a whole, or a combination of these. The goal does not necessarily have to be based on a positive result, but goals that are substantially certain to be achieved may not be used.
- Based on an objective formula, so that a third party with knowledge of the relevant performance results could calculate the award. If a formula specifies that payment is based on current salary, the objective formula requirement is satisfied if the maximum dollar amount that could be paid is fixed at the time that the performance goal is established. For example, the award is based on the salary in effect after the start of the performance cycle (and after the applicable grace period), but a maximum dollar amount is set within the grace period.

In a private letter ruling, the IRS clarified that a compensation committee, which establishes the maximum grant that may be made to each participant in an incentive plan within the first 90 days of the performance period and specifies the applicable performance goals for each individual, may wait until after the 90-day grace period to determine the actual grant amounts for each participant without causing the compensation to fail to qualify for the performance-based compensation exception (*PLR 200949005*).

If payment of compensation is only nominally or partially contingent on attaining a performance goal, none of the compensation payable under the award is considered performance-based. For example, if an employee is entitled to a bonus under either of two plans, and payment under the non-performance-based plan will be paid if the goals are not achieved under the performance-based plan, then neither of the plans provides for compensation that is performance-based. However, bifurcated plans with components that are not interdependent are considered separately, even if paid from the same bonus pool. In evaluating this issue, the facts and circumstances must be considered, taking into account all plans, arrangements and agreements that provide for compensation to employees.

More than One Performance Goal

If more than one performance goal is pre-established, the compensation committee's discretion to choose to pay a bonus under one of the goals does not cause the plan to fail to meet the performance-based requirements if each goal independently meets the requirements.

Similarly, shareholders may approve a number of different business criteria for setting performance goals and allow the compensation committee to select the appropriate criteria each year. However, the use of multiple criteria generally requires re-approval of the plan by shareholders at least every five years. For a sample bonus plan that sets out several different business criteria for setting performance goals, see *Standard Document, Annual Cash Bonus Plan (http://us.practicallaw.com/2-507-0586)*.

Adjusting Performance Goals

Adjustments to performance goals may be made anytime before the grace period for setting performance goals expires. However, if performance goals are to be adjusted outside of the grace period, the plan should set out the circumstances under which adjustments can be made.

When a plan provides that a performance goal will be adjusted in the case of certain specified events (such as an asset write-down or a change in tax laws or accounting standards), adjusting that performance goal in accordance with the plan does not constitute an exercise of impermissible discretion and the performance-based compensation exception under Section 162(m) still applies.

While including an adjustment provision in the plan provides some flexibility in particular foreseeable circumstances, it can be difficult to anticipate all of the potential circumstances under which adjustments may be appropriate. Some corporations therefore adopt a "plan within a plan" design, which preserves flexibility to reduce award amounts through the use of negative discretion (see *Use of Negative Discretion*).

COMPENSATION COMMITTEE

A corporation's compensation committee is the committee of directors (including any subcommittee of directors) that has the authority to establish and administer the applicable performance goals, and certify that the performance goals are met. The committee must consist solely of two or more outside directors.

Outside Directors

To be a qualified outside director, the director cannot:

- Be a current employee of the corporation.
- Be a former employee who receives compensation for prior service other than benefits under a qualified plan.
- Be a former officer of the corporation (see *Officer*). For example, the IRS held that an individual does not qualify as an "outside director" of a corporation when the individual has served as the corporation's interim CEO in regular and continued service with the full authority vested in that office (*Revenue Ruling 2008-32*).
- Receive remuneration directly or indirectly from the corporation in any capacity other than as a director.

Remuneration is considered received by a director if it is paid in:

- The current year, to an entity in which the director has a more than 50% ownership interest.
- The preceding year, to an entity in which the director has an at least 5% but less than 50% ownership interest (unless the remuneration is *de minimis*).
- The preceding year, to an entity by which the director is employed or self-employed other than as a director (unless the remuneration is *de minimis*).

Remuneration is considered *de minimis* if it is 5% or less of the receiving entity's gross revenue (for its taxable year ending with or within the preceding taxable year of the publicly held corporation). However, it must also not exceed $60,000 if paid either:

- To an entity in which the director owns between 5% and 50%.

- For personal services to an entity by which the director is employed or self-employed other than as a director. For more information on the personal services *de minimis* threshold, see Treas. Reg. Section 1.162-27(e)(3)(iii)(B).

Officer

Determining whether an individual is or was an officer is based on all of the facts and circumstances in the particular case, including:

- The source of the individual's authority.
- The term for which the individual is elected or appointed.
- The nature and extent of the individual's duties.

SHAREHOLDER APPROVAL REQUIREMENTS

Performance-based compensation does not qualify for exclusion from the Section 162(m) deduction limitation unless the material terms of the performance goal under which the compensation will be paid are disclosed to and approved by shareholders before the compensation is paid. The following terms must be disclosed:

- **Eligible employees.** A description by title or class is sufficient (all key employees). Individual names do not need to be disclosed.
- **Business criteria.** The business criteria on which the goal is based, but not the actual targets that must be satisfied (for example, earnings per share, total shareholder return or return on equity). A plan that provides for grants of stock options or stock appreciation rights (SARs) granted with an exercise price at least equal to fair market value on the grant date is exempt from this disclosure.
- **Maximum compensation or formula.** The maximum amount of compensation that could be paid to any employee during a specified period or the formula for calculating the amount of compensation to be paid to the employee if the performance goal is attained (see *Maximum Compensation or Formula*).

The shareholder approval requirement is not satisfied if the compensation would be paid regardless of whether the material terms are approved by shareholders.

In certain circumstances, a bankruptcy court's approval of performance-based incentive plans is deemed to meet the shareholder approval requirements of Section 162(m).

Maximum Compensation or Formula

The company's disclosure must be sufficient for shareholders to determine the maximum dollar amount payable if the performance goal is achieved. The disclosure must generally include either:

- The maximum amount of compensation that could be paid to any employee.
- The formula used to calculate the amount to be paid to the employee if the performance goal is attained.

In the case of a formula that is based on a percentage of an employee's base salary, the company must disclose both:

- The formula used to calculate the amount of compensation to be paid to the employee if the performance goal is achieved.
- The maximum dollar amount of compensation that could be paid.

For options or SARs, the maximum number of shares that can be granted per employee during a specified period and the exercise price (for example, fair market value at the date of grant) must be disclosed. For other equity-based awards, the maximum number of shares that can be granted per employee during a specified period must be disclosed.

Disclosure of Confidential Information Not Required

The disclosure of a material performance goal is not required if the compensation committee determines that the information is confidential commercial or business information, the disclosure of which would have an adverse effect on the company. Confidential information does not include the identity of an executive or the class of executives to which a performance goal applies or the amount of compensation that is payable if the goal is satisfied.

Frequency With Which Material Plan Terms Must Be Disclosed to Shareholders

Once the material terms of a plan are approved by shareholders, no additional disclosure is required unless the compensation committee changes the material terms of the performance goal. If, however, the committee has the authority to change the targets under a performance goal, the material terms of the plan must be re-approved by shareholders by the first shareholder meeting that occurs in the fifth year after the year that the shareholders previously approved the performance goal. Therefore, if a plan includes a list of business criteria that the compensation committee may use when setting performance goals, shareholder re-approval is required every five years.

When an acquiror acquires a company with a plan that has already been approved by the acquired company's shareholders and the acquiring company assumes the plan and extends it to cover some of its own employees, the plan continues to meet the shareholder approval requirement of Section 162(m). There is no need to have the plan reapproved by the acquiring company's shareholders as a result of the acquisition.

CERTIFYING ACHIEVEMENT OF PERFORMANCE GOALS

The compensation committee must certify in writing that the performance goals and any other material terms are satisfied before compensating a covered employee. Approved minutes of the compensation committee meeting in which certification is made are treated as written certification. Certification is not required for compensation attributable solely to the increase in the corporation's stock value (for example, compensation paid on exercise of stock options or SARs).

USE OF NEGATIVE DISCRETION

The compensation committee can use its discretion to reduce or eliminate the award otherwise payable to a covered employee under the formula, but not increase it. However, the exercise of negative discretion with respect to one employee may not result in an increase in the amount paid to another employee (for example, in the case of a bonus pool). To maximize flexibility, some companies adopt a "plan within a plan" or "umbrella plan" design under which they set large maximum award amounts and then reduce them through the use of negative discretion. Under this approach, the plan consists of both an "outside" plan and an "inside" plan.

Generally, the outside plan establishes a performance formula that:

- Sets out a large maximum award amount.
- Satisfies Section 162(m)'s requirements.

The inside plan sets out a second formula that generally provides greater specificity with respect to the terms of individual awards. While the company may not intend to pay the maximum award amounts under the outside plan, the plan within a plan approach gives the compensation committee the flexibility to pay awards that are higher than those payable under the inside plan's formula. Award amounts ultimately paid to participants that are lower than the outside plan maximum are considered a permissible exercise of negative discretion under the outside plan.

This plan design can pose challenges however, because:

- The design is inherently complicated and can be challenging to describe both to internal audiences at the company and in the company's annual proxy statement.
- Shareholders may be resistant to the large potential award amounts permitted under the outside plan.

TYPES OF PERFORMANCE-BASED COMPENSATION

Only certain types of compensation can qualify for the performance-based compensation exception.

BONUSES

Bonuses that are paid based on a percentage of a corporation's annual sales are not substantially uncertain enough to be performance-based because the corporation is virtually certain to have some sales for the fiscal year.

However, bonuses that are paid based on a percentage of a corporation's annual profits (or related measures) are substantially uncertain and are, therefore, performance-based. This is the case even if the company has a history of profitability.

In the case of a bonus pool, if the amount payable to each covered employee is stated in terms of a percentage of the pool, the sum of the individual percentages of the pool may not exceed 100%, and the failure to pay someone his full percentage may not result in an increased payment to another covered employee.

EQUITY COMPENSATION AWARDS

For a grant of stock options or SARs to qualify as performance-based compensation for purposes of Section 162(m), the grant must be made:

- By the compensation committee (see *Compensation Committee*).
- Under a plan that specifies the maximum number of shares that may be granted to any individual employee during a specified period. An overall plan limit is not sufficient to meet this requirement; an explicit individual limit is required.
- The compensation received must be based solely on an increase in the value of the stock after the grant date (and therefore the exercise price must be no lower than the fair market value of the underlying stock on the grant date).

On June 23, 2011, the IRS proposed regulations under Section 162(m) (Proposed Regulations) which clarify that if a plan document sets out the maximum number of shares that may be granted under the plan but does not include the maximum number of stock options or SARs that may be granted to any individual employee during a specified period, the stock options and SARs will not be qualified performance-based compensation. It appears permissible under the Proposed Regulations for the per-person limit to be the same as the maximum number of shares available under the plan.

In the case of stock options and SARs, if the above requirements are met, neither the grant nor vesting of the award must be contingent on attaining a qualifying performance goal. Options that are cancelled or repriced reduce the maximum number of shares for which options may be granted to the employee.

However, grants of restricted stock or RSUs cannot qualify as performance-based compensation unless the grant or vesting is contingent on attaining a qualifying performance goal.

Dividends

Dividends or dividend equivalent rights paid on qualified performance-based restricted stock and performance shares do not disqualify the plan from being performance-based compensation. However, the dividends and dividend equivalent rights themselves are subject to the Section 162(m) deduction limit unless they separately satisfy the requirements of the performance-based compensation exception. In Revenue Ruling 2012-19, the IRS clarified that where dividends and dividend equivalent rights relating to performance-based restricted stock and restricted stock unit awards are paid currently, without regard to whether the performance goals for the restricted stock and the restricted stock units (or alternative goals) are satisfied, the payment of dividends and dividend equivalent rights will not cause the restricted stock and the restricted stock units to fail to satisfy the performance-based compensation exception. However, the payment of dividends and dividend equivalents will not qualify as performance-based compensation and therefore may not be deductible.

Dividend equivalent rights paid on options do not disqualify the options from being performance-based compensation, but only if the payment of the dividend equivalent rights is not conditioned on the employee exercising the options. Otherwise, the IRS considers the payment of dividend equivalent rights to be similar to a reduction of the option purchase price and that effectively creates a "discounted" option.

Modifying Stock-based Compensation Awards

Changes to a stock option, SAR or other stock-based compensation do not cause the compensation to fail to qualify as performance-based to the extent that the change in the grant or award is made to reflect a change in the following:

- A corporate capitalization, such as a stock split or dividend.
- A corporate transaction, such as a merger of a corporation into another corporation.
- Any consolidation of two or more corporations into another corporation.
- Any separation of a corporation (including a spin-off or other distribution of stock or property by a corporation).
- Any reorganization of a corporation (whether or not the reorganization is within the definition of such term in IRC Section 368).
- Any partial or complete liquidation by a corporation.

When permitted by the plan, the number and exercise price of stock options can be adjusted to reflect the impact of corporate events, and the requirements of Section 162(m) are met if the adjustments are made in a manner that is consistent with the methodology provided in IRC Section 424(a) (relating to corporate reorganizations and liquidations).

Accelerating Stock Option Exercisability

Amending outstanding stock options to accelerate their exercisability does not cause them to fail to qualify as performance-based compensation.

COMPENSATION THAT IS NOT PERFORMANCE-BASED COMPENSATION

Certain types of compensation do not qualify as performance-based compensation, including the following.

PAYMENTS ON TERMINATION WITHOUT CAUSE, RESIGNATION FOR GOOD REASON OR RETIREMENT

Under Revenue Ruling 2008-13, compensation fails to qualify as performance-based compensation if the plan provides that compensation is paid regardless of whether the performance goal is met in these situations:

- The covered employee:
  - is involuntarily terminated by the corporation without cause; or
  - terminates his employment for good reason.
- The covered employee retires.

This disqualifying rule applies even if:

- The compensation does not, in fact, become payable in connection with the termination.
- The applicable performance goals are, in fact, achieved.

Two exceptions to this rule allow a deduction for compensation paid on termination of employment by the corporation without cause, termination by the executive for good reason or retirement that otherwise satisfies the requirements for qualified performance-based compensation if either:

- The performance period for the compensation began on or before January 1, 2009.
- The compensation is paid according to the terms of an employment contract as in effect on February 21, 2008 (without regard to future renewals or extensions, including renewals or extensions that occur automatically without further action by one or more of the parties to the contract).

PAYMENTS ON DEATH OR DISABILITY

Compensation does not fail to qualify as performance-based compensation merely because the plan allows for payment on death or disability. However, payment actually made on account of one of these events before the performance goal is attained does not qualify as performance-based and is subject to the Section 162(m) limit.

PAYMENTS ON A CHANGE IN CONTROL

Compensation does not fail to qualify as performance-based compensation merely because the plan allows for payment on a change in control or termination following a change in control. However, payment actually made on account of a change in control before the performance goal is attained does not qualify as performance-based compensation and is subject to the Section 162(m) limit. If, on the other hand, a plan provides for payment on termination following a change in control, then following a change in control, the disqualifying rule above (see *Payments on Termination Without Cause, Resignation for Good Reason or Retirement (http://us.practicallaw.com/2-518-7869)*) will apply and the payments may not qualify as performance-based compensation even if paid on achievement of the applicable performance goals.

COMPANIES THAT BECOME PUBLIC COMPANIES

The following special rules apply to compensation paid by private companies that later become publicly held.

NEWLY PUBLIC COMPANIES

Remuneration paid according to a compensation plan or agreement that exists during a period that the corporation is not publicly held is excluded from the Section 162(m) limit. However, in the case of a corporation that becomes publicly held through an initial public offering (IPO), the exception for newly public companies applies only to the extent that the prospectus accompanying the IPO discloses information concerning those plans or agreements that satisfies all applicable securities laws then in effect.

This exception may be relied on until the earliest of:

- The plan or agreement expiring or being materially modified.
- All employer stock or other compensation that has been allocated under the plan being issued.
- For privately held companies that become public with an IPO, the first annual shareholder meeting at which directors are to be elected that occurs after the close of the third calendar year following the calendar year that the IPO occurs.
- For privately held companies that become public without an IPO, the first annual shareholder meeting at which directors are to be elected that occurs after the close of the first calendar year following the calendar year that the corporation becomes publicly held.

Compensation received from stock options, SARs or restricted stock is covered by this rule if the option, SAR or restricted stock was granted before the end of the transition period, regardless of when it is exercised or vests, as applicable. The Proposed Regulations provide that this exception does not apply to other forms of equity compensation, such as RSUs or phantom stock. Therefore, subject to finalization of the Proposed Regulations, it should be assumed that RSUs and phantom stock granted during the transition period will be excluded from the Section 162(m) limit only if paid before the transition period expires.

SUBSIDIARIES THAT BECOME PUBLIC

Special transition rules apply for subsidiaries of public companies that become separate publicly held companies (whether by spin-off or otherwise). Generally, the compensation arrangements must:

- Meet the requirements for establishing performance goals.
- Satisfy the shareholder approval requirements.
- Be approved by outside directors of the old company before the spin-off.

In addition, the compensation committee at the new company must certify that the performance goals were achieved.

Alternatively, the arrangements can be approved by the compensation committee of either the old or new company. In that case, the arrangement does not need to satisfy the shareholder approval requirement. However, the alternative is only available for compensation paid or equity awards granted before the new company's first annual meeting that occurs at least 12 months after the spin-off.

LOWER DEDUCTION LIMITS FOR HEALTH INSURANCE PROVIDERS

The Affordable Care Act (ACA), the health care reform legislation enacted in March 2010, added Section 162(m)(6) to the IRC and imposes an additional deduction limit on compensation paid by health insurance issuers who are covered health insurance providers (CHIPs). Whether a health insurance issuer is a CHIP must be determined for each taxable year. A CHIP may not deduct compensation paid to an individual in excess of $500,000 per year. The deduction limit generally applies to all CHIPs, regardless of whether they are publicly held corporations. However, final regulations under Section 162(m)(6) include a *de minimis* rule which exempts a CHIP if the premiums it receives from providing health insurance coverage that is minimum essential coverage, when aggregated with the premiums received by certain of its affiliates, are less than 2% of gross revenues annually.

The deduction limit does not only apply to compensation paid to covered employees; it applies to compensation paid to all individuals providing services to the health insurance provider or its applicable affiliates, including consultants and non-employee directors. In IRS Notice 2011-2, the IRS clarified that the deduction limit also applies to an independent contractor, unless the independent contractor provides substantial services to multiple unrelated customers. Section 162(m)(6) does not exclude from the deduction limit performance-based compensation or commission-based compensation. For further information, see *Practice Note, Section 162(m)(6) of the Code: Limit on Deduction for Compensation Paid by Health Insurers under Health Care Reform (http://us.practicallaw.com/9-521-2747)*.

COORDINATION BETWEEN SECTION 162(M) AND SECTION 409A

Section 409A governs nonqualified deferred compensation arrangements. A payment that would otherwise qualify as a short-term deferral under Section 409A (see *Practice Note, Section 409A: Deferred Compensation Tax Rules: Overview: Short-term Deferral Exception (http://us.practicallaw.com/6-501-2009#a494148)*) that is made after the applicable 2½ month short-term deferral period may continue to qualify as a short-term deferral if the company establishes that:

- It reasonably anticipated that the deduction for the payment would not be permitted by Section 162(m) if the payment were made within the short-term deferral period.
- As of the date that the right to the payment arose, a reasonable person would not have anticipated the application of Section 162(m) at the time of the payment.
- The payment is made as soon as reasonably practicable after the first date that the company anticipates, or reasonably should anticipate, that if the payment were made on that date, the deduction would not be restricted due to Section 162(m).

PAYMENTS SUBJECT TO SECTION 409A

A payment subject to Section 409A may be delayed to the extent that the company reasonably anticipates that if the payment were made as scheduled, the deduction would not be permitted due to Section 162(m), provided that the payment is made either during the:

- Officer's first taxable year that the company reasonably anticipates, or should reasonably anticipate, that if the payment is made during that year, the deduction will not be barred by Section 162(m).
- Period beginning with the date of the officer's separation from service and ending on the later of the:
  - last day of the taxable year of the company in which the officer separates from service; or
  - 15th day of the third month following the officer's separation from service.

  All scheduled payments to the officer that can be delayed in accordance with this rule must be delayed.

Where the payment is delayed to a date on or after the officer's separation from service, the payment is considered a payment on a separation from service for purposes of Section 409A. Therefore, in the case of a specified employee, the payment must be delayed for six months (see *Practice Note, Specified Employees under Section 409A (http://us.practicallaw.com/7-501-1330)*). The company cannot provide the officer with an election concerning the timing of the delayed payment.

PROCEDURAL SAFEGUARDS

Compliance with Section 162(m) is a common area of focus for the IRS when conducting audits of executive compensation issues. In addition, in recent years, companies have become vulnerable to shareholder suits alleging technical violations of Section 162(m); specifically the requirements of the performance-based compensation exception. To minimize the risk of a Section 162(m)-related claim, or the reversal of a tax deduction by the IRS, companies should consider adopting the following procedural safeguards:

- Establish an intra-company program to educate select individuals about Section 162(m)'s requirements.
- Include confirmation of Section 162(m) compliance as a formal step in the company's grant procedures.
- Limit the ability to negotiate and enter into employment agreements and other individual compensatory arrangements to a small group of individuals who are knowledgeable about Section 162(m).

02-15