Section 162(m): Limit on Compensation

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A Practice Note providing a summary of the $1 million annual deduction limitation on certain executive compensation imposed on publicly held companies by Section 162(m) of the Internal Revenue Code (Section 162(m)). This Note has been updated to reflect the changes made to Section 162(m) by the Tax Cuts and Jobs Act (the Act), which are effective for taxable years beginning after December 31, 2017, unless the compensation arrangement is grandfathered under the transition rule. This Note has also been updated to reflect Notice 2018-68, which provides initial guidance on the application of certain aspects of the amendments made to Section 162(m) by the Act, including identifying covered employees and applying the transition rule.

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

- 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) (26 U.S.C. § 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.
- The scope of compensation that is subject to Section 162(m).
- The relationship between Section 162(m) and other tax rules that separately impact executive compensation.

This Note has been updated to reflect the changes made to Section 162(m) by the Tax Cuts and Jobs Act (the "Act"), which are effective for taxable years beginning after December 31, 2017, unless the compensation arrangement is grandfathered under the transition rule. The updates are based on the statutory language of the Act and the commentary in the Joint Explanatory Statement released by the House-Senate Conference Committee (the "Joint Explanatory Statement"), particularly regarding the transition rule. In addition, this Note reflects the guidance issued under Notice 2018-68 on the application of certain aspects of the amendments made to Section 162(m) by the Act, including identifying covered employees and applying the transition rule. For information on the impact of the Act on executive compensation and employee benefits generally, see Legal Update, Tax Reform Is Enacted With Significant Implications for Executive Compensation and Employee Benefits (W-012-3270).

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 annual deduction limit under Section 162(m).

Effective for taxable years beginning after December 31, 2017, a "publicly held corporation" means any corporation which is either:

- An "issuer" (as defined in Section 3 of the Securities Exchange Act of 1934, as amended (Exchange Act) of securities that are required to be registered under Section 12 of the Exchange Act.
- An issuer that is required to file reports under Section 15(d) of the Exchange Act.

Under this definition, corporations subject to Section 162(m) include those with publicly traded equity and publicly traded debt, as well as foreign private issuers that meet the new definition of a publicly held corporation (even if not subject to the executive compensation disclosure rules of the Exchange Act), including those publicly traded through American Depositary Receipt (ADR) programs.

COMPANIES SUBJECT TO SECTION 162(M) BEFORE 2018

Effective for taxable years beginning before December 31, 2017, a "publicly held corporation" means any corporation that issues any class of common equity securities that are required to be registered under Section 12 of the Exchange Act.

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. However, 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 has held 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.
- The 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.

(PLR 200837024; PLR 200727008.)

SHORT TAX YEARS ENDING WITH MERGERS

Prior to the changes made by the Act, the IRS had held that 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 (PLR 200951006). Subject to further guidance, the Joint Explanatory Statement may have changed this rule, as it indicates that covered employees of a publicly traded corporation that would otherwise have been required to file a proxy statement for the year but for the fact that the corporation underwent a transaction that resulted in the non-application of the proxy statement requirement, would be subject to Section 162(m).

COVERED EMPLOYEES

Effective for taxable years beginning after December 31, 2017, for purposes of Section 162(m), a "covered employee" means any employee of the taxpayer who:

- Is the principal executive officer (PEO) or principal financial officer (PFO) of the taxpayer at any time during the taxable year (or was an individual acting in such a capacity).
- Is among the three highest compensated officers for the taxable year (excluding the PEO and the PFO) whose compensation for the taxable year is required to be reported to shareholders under the Securities and Exchange Commission's (SEC's) executive compensation disclosure rules.
- Was a covered employee of the taxpayer (or any predecessor) for any taxable year beginning after December 31, 2016.

The three highest compensated officers for the taxable year (excluding the PEO and the PFO) are determined by looking to the rules relating to the disclosure of compensation in the company's proxy statement for the taxable year. The Joint Explanatory Statement indicates that this includes officers of a corporation not required to file a proxy statement, but which otherwise falls within the definition of a "publicly held corporation," as well as officers of a publicly traded corporation that would otherwise have been required to file a proxy statement for the year (for example, but for the fact that the corporation delisted its securities or underwent a transaction that resulted in the non-application of the proxy statement requirement).

Notice 2018-68 clarifies that any employee who serves as the PEO, the PFO or one of the three highest compensated executive officers for the taxable year will qualify as a covered employee, regardless of whether that employee is an executive officer at the end of that year (that is, there is no requirement that a covered employee be employed at year end) and regardless of whether that individual's compensation is required to be disclosed for the last completed fiscal year under the SEC's rules, including for smaller reporting companies (SRCs) and emerging growth companies (EGCs) (see Smaller Reporting Companies and Emerging Growth Companies). As a result, it is possible for individuals who are not listed as named executive officers in the annual proxy statement to be covered employees if their compensation exceeded the compensation of the three other most highly compensated officers who were employed on the last day of the taxable year. It is also possible that an individual who is listed as a named executive officer in the annual proxy statement may not be a covered employee (for example, if that individual was included among a group of five named executive officers (other than the PEO and the PFO), consisting of the three highest compensated officers other than the PEO and the PFO who were serving at year-end and two additional individuals for whom such disclosure would have been provided but for the fact that they were not serving at year-end, and that individual was not among the three highest compensated officers other than the PEO and the PFO for purposes of Section 162(m)).

In addition, if an individual is a covered employee with respect to a corporation for a taxable year beginning after December 31, 2016, that individual remains a covered employee for all future years, including after termination of employment or even death. Notice 2018-68 clarifies that covered employees identified for the taxable year beginning in 2017 in accordance with the pre-Act rules for identifying covered employees (as the new rules for identifying covered employees do not apply to the company's 2017 taxable year – see Covered Employees Before 2018) will continue to be covered employees for all taxable years beginning in 2018 and beyond. In addition, the Joint Explanatory Statement indicates that compensation does not fail to be compensation with respect to a covered employee merely because the compensation is includible in the income of, or paid to, another individual, such as compensation paid to a beneficiary after the covered employee's death, or to a former spouse of the covered employee pursuant to a domestic relations order.

COVERED EMPLOYEES BEFORE 2018

Effective for taxable years beginning before December 31, 2017, a "covered employee" means any employee of the taxpayer who is either:

- The PEO of the taxpayer as of the close of the taxable year (or is an individual acting in that capacity).
- Among the three highest compensated officers (excluding the PEO and the PFO) whose compensation for that taxable year is required to be reported to shareholders under the SEC's executive compensation disclosure rules.

Although certain covered employees are determined by looking to the SEC executive compensation disclosure rules, the definition of a "covered employee" does not mirror the definition of named executive officer provided in Item 402(a)(3) of Regulation S-K. For example, even though the PFO is a named executive officer, the PFO is not a covered employee under Section 162(m) (IRS Notice 2007-49).

Also, 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 (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).

SMALLER REPORTING COMPANIES AND EMERGING GROWTH COMPANIES

Certain registrants, including SRCs and EGCs, may elect to disclose executive compensation under the reduced disclosure requirements of Item 402(m) of Regulation S-K (17 C.F.R. § 229.402(m)). Under these rules, the registrant only needs to disclose the compensation of its PEO and its two most highly compensated executive officers.

Notice 2018-68 clarifies that the new definition of "covered employee" under the Act (see Covered Employees) will apply to SRCs and EGCs, even though SRCs and EGCs may elect to disclose executive compensation for fewer individuals than other public companies. Prior to the changes made by the Act, the IRS had held that the PFO whose compensation is disclosed under Item 402(m) of Regulation S-K (applicable to SRCs and EGCs) is a covered employee for purposes of Section 162(m) (IRS CCA 201543003).

For the determination of SRC status and a description of the differences in executive compensation disclosures for SRCs and other reporting companies, see Practice Note, Determining Smaller Reporting Company Status and Understanding Key Differences in Its Disclosure and Reporting Requirements: Executive Compensation (Item 402) (9-506-5812). For the determination of EGC status and a description of the differences in executive compensation disclosures for EGCs and other reporting companies, see Practice Note, JOBS Act: On-Ramp to the Capital Markets for Emerging Growth Companies Summary (1-518-7351).

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 applies to the taxable year in which the deduction would otherwise be taken by the corporation. For example, the deduction is generally taken:

- For bonus payments, in the year in which the bonus is earned or paid.
- For non-qualified stock options, in the year in which the option is exercised.
- For restricted stock, in the year in which the stock vests (unless a timely election under Code Section 83(b) (26 U.S.C. § 83(b)) has been made.
- For restricted stock units (RSUs), in the year in which the RSUs are settled.

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).
- Solely with respect to either taxable years beginning on or before December 31, 2017 or remuneration paid pursuant to a written binding contract that was in effect on November 2, 2017, and was not materially modified on or after that date (see Transition Rule), in either case, commission-based compensation (see Commission-Based Compensation) or qualified performance-based compensation (see Qualified Performance-Based Compensation).

TRANSITION RULE

The changes made to Section 162(m) by the Act include:

- The elimination of the qualified performance-based compensation exception.
- The elimination of the commission-based compensation exception.
- The expansion of the definition of "covered employee."
- The expansion of the definition of "publicly held corporation."

These changes do not apply to compensation payable pursuant to a written binding contract that was in effect on November 2, 2017, and is not materially modified after that date (this is commonly referred to as the "transition rule").

GUIDANCE UNDER THE JOINT EXPLANATORY STATEMENT

According to the Joint Explanatory Statement, the fact that a plan was in existence on November 2, 2017 is not by itself sufficient to qualify the plan for the transition rule. The transition rule no longer applies to amounts paid after there has been a material modification to the terms of the contract. In addition, the transition rule ceases to apply to new contracts entered into or renewed after November 2, 2017. For this purpose, any contract that is entered into on or before November 2, 2017 and that is renewed after that date is treated as a new contract entered into on the effective date of the renewal. If a contract is terminable or cancelable unconditionally at will by either party to the contract without the consent of the other, or by both parties to the contract, then that contract will be treated as a new contract entered into on the date that such termination or cancellation, if made, would be effective. However, a contract is not treated as terminable or cancellable as such if it can be terminated or cancelled only on a termination of the covered employee's employment relationship.

The Joint Explanatory Statement includes an example of a contract that would be grandfathered under the transition rule in the case of a covered employee who was hired by a company on October 2, 2017 pursuant to a written employment contract that provides for eligibility to participate in the company's executive deferred compensation plan. Under the terms of this plan:

- Participation occurs after six months of employment.
- Amounts payable under the plan are not subject to discretion.
- The company does not have the right to materially amend the plan or terminate the plan, except on a prospective basis before any services are performed for the period for which compensation is to be paid.

In this case, payments under the plan would be grandfathered, even though the employee was not actually a participant in the plan on November 2, 2017, provided that the plan is not materially modified after that date.

GUIDANCE UNDER NOTICE 2018-68

Notice 2018-68 provides important guidance for purposes of determining:

- Compensation that is payable pursuant to a written binding contract that was in effect on November 2, 2017.
- What constitutes a material modification to a written binding contract under the transition rule, including:
  - the impact of a negative discretion clause; and
  - the application to first-time covered employees.

Compensation is payable under a written binding contract that was in effect on November 2, 2017, only to the extent the company is obligated under applicable law (for example, state contract law) to pay the compensation if the employee performs services or satisfies applicable vesting conditions. Therefore, the amendments to Section 162(m) made by the Act apply to any amount of compensation that exceeds the amount that applicable law obligates the company to pay under a written binding contract that was in effect on November 2, 2017, if the employee performs services or satisfies the applicable vesting conditions.

Notice 2018-68 provides that a company is not considered to be legally obligated to pay amounts for purposes of Section 162(m) if under applicable state law the amount may be reduced or eliminated upon the company's exercise of negative discretion, regardless of whether that discretion is actually exercised. Notice 2018-68 provides an example of a bonus plan that was in effect on November 2, 2017 and that was structured to comply with the qualified performance-based exception under the pre-Act rules of Section 162(m). The plan provided that the PEO would receive a cash bonus of $1,500,000 if a specified performance goal was satisfied, subject to the compensation committee's right, in its discretion, to reduce the bonus payment to no less than $400,000. The compensation committee subsequently certified that the performance goal was satisfied and then exercised its negative discretion to reduce the bonus award to $500,000. The compensation committee's failure to exercise negative discretion to reduce the award to $400,000, instead of $500,000, does not result in a material modification. Notice 2018-68 provides that the minimum payment of $400,000 is not subject to the deduction limitation under Section 162(m), and the remaining $100,000 of the $500,000 payment is subject to the deduction limitation under Section 162(m), regardless of whether the payment satisfies the qualified performance-based exception under the pre-Act rules of Section 162(m). Based on the guidance under Notice 2018-68, it follows that if a compensation committee retains negative discretion to reduce a payout to a covered employee to $0 under a plan that was in effect on November 2, 2017, then none of the compensation payable pursuant to the underlying plan would be grandfathered, unless the covered employee is entitled to payment under applicable state law.

Many companies have designed their annual bonuses, performance stock units and other performance-based incentives to comply with the qualified performance-based exception under the pre-Act rules of Section 162(m) by providing for award amounts that are contingent on the attainment of one or more pre-established, objective performance goals and subject to reduction by the compensation committee through the use of negative discretion. Based on Notice 2018-68, the existence of a negative discretion clause will generally cause the payout of those awards to not be grandfathered under the transition rule unless the covered employee has an entitlement to an amount under applicable state law.

Note that stock options or stock appreciation rights that were granted pursuant to written binding contracts on or prior to November 2, 2017 should generally remain grandfathered under the transition rule, provided that the terms are not materially modified thereafter, because the elimination of the qualified performance-based exception by the Act does not apply to the extent that such stock options or stock appreciation rights satisfied the requirements for qualified performance-based compensation under the pre-Act rules of Section 162(m) (see Equity Compensation Awards). However, a promise to grant stock options or stock appreciation rights to an employee pursuant to an employment agreement in effect on November 2, 2017, and which is subject to approval by the board of directors at a later date, should not constitute a written binding contract under applicable law based on an example provided under Notice 2018-68.

Under Notice 2018-68, if an individual becomes a covered employee solely as a result of the amendments to Section 162(m) by the Act, then any payments that are made to that individual pursuant to a written binding contract that was in effect on November 2, 2017 will not be subject to Section 162(m). Notice 2018-68 includes an example under which the PFO of a company is entitled to payment of an annual salary of $2,000,000 for three years through December 31, 2020 pursuant to a written binding employment agreement that was in effect as of November 2, 2017. The PFO first becomes a covered employee for the taxable year beginning January 1, 2018 as a result of the amendments to Section 162(m) made by the Act. Notice 2018-68 provides that the annual salary of $2,000,000 payable to the PFO for the 2018, 2019 and 2020 taxable years pursuant to the employment agreement will not be subject to the deduction limitation under Section 162(m).

Consider another example in which a PEO entered into a nonqualified deferred compensation arrangement that is an account balance plan. Under the terms of the plan, the PEO defers annual salary that becomes payable on a separation from service and, under applicable law, the plan constitutes a written binding contract that was in effect on November 2, 2017. As of November 2, 2017, the PEO had deferred a total of $1,000,000 of annual salary. Because, as of November 2, 2017, the amount that is required to be paid pursuant to the written binding contract is $1,000,000, this amount would not be subject to the deduction limitation under Section 162(m), provided, that the contract is not materially modified thereafter.

Notice 2018-68 confirms that if a written binding contract that was in effect on November 2, 2017 is materially modified after that date, it is treated as a new contract entered into as of the date of the material modification. Any amounts received by an employee under the contract before a material modification remain grandfathered, but any amounts received subsequent to the material modification are treated as paid pursuant to a new, non-grandfathered contract, rather than pursuant to a grandfathered contract in effect on November 2, 2017. A "material modification" occurs when a written binding contract is amended or modified to:

- Increase the amount of compensation payable to the employee.
- Accelerate the payment of compensation, unless the amount of compensation paid is discounted to reasonably reflect the time value of money.
- Defer the payment of compensation, unless the amount of compensation paid or to be paid at a later date that is in excess of the amount originally payable to the employee under the contract is based on either:
  - a reasonable rate of interest; or
  - the actual rate of return on a predetermined actual investment, including any decrease, as well as any increase, in the value of the investment (whether or not assets associated with the amount originally owed are actually invested therein).

In addition, Notice 2018-68 provides that the adoption of a supplemental contract or agreement that provides for increased compensation, or the payment of additional compensation, will constitute a material modification of a written binding contract that was in effect on November 2, 2017, if the facts and circumstances demonstrate that the additional compensation is paid on the basis of substantially the same elements or conditions as the compensation that is otherwise paid under the written binding contract. However, a material modification will not occur under these facts and circumstances if either the amount of the supplemental payment is equal to or less than a reasonable cost-of-living increase over the payment made in the preceding year under that written binding contract or there has been a failure, in whole or in part, to exercise negative discretion under that written binding contract. It is unclear how this rule would apply to a single contract with provisions that provide for different types of compensation and, subject to further guidance that may be issued, it appears that amending one type of compensation should generally not result in a loss of grandfathered status for the remaining types of compensation under that contract based on the rules relating to supplemental contracts.

Consistent with the Joint Explanatory Statement, Notice 2018-68 provides that the changes to Section 162(m) made by the Act will apply to a written binding contract that is renewed after November 2, 2017, so that the transition rule will cease to apply as of the date of renewal and amounts paid after the date of renewal will be subject to Section 162(m) as amended by the Act. If a written binding contract may be terminated or cancelled by the company without the employee's consent after November 2, 2017, then it will be treated as renewed as of the date on which such cancellation or termination, if made, would be effective. For example:

- If the terms of a contract provide for automatic renewal or extension as of a specified date (for example, January 1, 2020), unless either the company or the employee provides at least 30 days' advance notice of termination, then the contract will be treated as renewed as of that specified date (in this example, January 1, 2020), which is the date that the termination would be effective if notice were given.
- If the terms of a contract provide that the contract will be terminated or canceled as of a specified date (for example, January 1, 2020), unless either the company or the employee elects to renew the contract within 30 days of that specified date (in this example. January 1, 2020), then the contract will be treated as renewed by the company as of that specified date (January 1, 2020), unless the contract is actually renewed before that specified date (before January 1, 2020), in which case, the contract is treated as renewed on the actual date of renewal.

However, if the company will remain legally obligated by the terms of the contract beyond a specified date (for example, January 1, 2020) in the sole discretion of the employee, then the contract will not be treated as renewed as of that date (January 1, 2020) if the employee actually exercises his or her discretion to keep the company bound to the contract. A contract is not treated as terminable or cancelable if the contract can only be terminated or canceled by terminating the employment relationship of the employee.

In addition, a contract is not treated as renewed if the employment relationship continues following the termination or cancelation of the contract and would no longer be covered by the contract. However, if an individual's employment continues after such termination or cancellation of the contract, then payments made with respect to such employment are not made under that contract, and, therefore, are not grandfathered.

Notice 2018-68 also provides that if a compensation plan or arrangement is binding, then the amount that is required to be paid as of November 2, 2017 to an employee under that plan or arrangement will be grandfathered, even for an employee who was not eligible to participate in that plan or arrangement as of November 2, 2017. However, the changes to Section 162(m) made by the Act will apply to that compensation plan or arrangement, unless the employee was employed on November 2, 2017 by the company that maintained the plan or arrangement or otherwise had the right to participate in the plan or arrangement under a written binding contract as of November 2, 2017.

COMMISSION-BASED COMPENSATION BEFORE 2018 AND GRANDFATHERED ARRANGEMENTS

For taxable years beginning on or before December 31, 2017 or remuneration paid pursuant to a written binding contract that was in effect on November 2, 2017, and was not materially modified on or after that date, the $1 million annual deduction limit does not apply to commission-based compensation generated directly by the individual (not a group or business unit).

Note that, 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 BEFORE 2018 AND GRANDFATHERED ARRANGEMENTS

For taxable years beginning on or before December 31, 2017 or remuneration paid pursuant to a written binding contract that was in effect on November 2, 2017 and is not materially modified on or after that date, the $1 million annual deduction limit does not apply to remuneration 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 which is composed solely of two or more outside directors (see Compensation Committee).
- **Shareholder approval.** Before payment, shareholders in a separate vote must approve the material terms under which the compensation is to be paid; 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 performance-based compensation exception, the performance goal must be:

- Established in writing by the compensation committee 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 (provided that the outcome is substantially uncertain at the time the compensation committee establishes the goal); 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 determine whether the goal is met. 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 (2-507-0586).

Adjusting Performance Goals

Adjustments to performance goals may be made any time 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 have adopted 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 compensation 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 publicly held corporation.
- Be a former employee of the publicly held corporation who receives compensation for prior service other than benefits under a tax-qualified retirement plan during the taxable year.
- Be a former officer of the publicly held 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 publicly held corporation in any capacity other than as a director.

Remuneration is considered received, directly or indirectly, by a director if it is paid in:

- The current taxable year of the publicly held corporation, to the director personally or to an entity in which the director has a more than 50% beneficial ownership interest.
- The preceding taxable year of the publicly held corporation, to an entity in which the director has an at least 5% but less than 50% beneficial ownership interest (unless the remuneration is *de minimis*).
- The preceding taxable year of the publicly held corporation, 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, the remuneration 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 26 C.F.R. § 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 (such as all key employees). Individual names do not need to be disclosed.
- **Business criteria.** The business criteria on which the performance goal is based, but not the specific targets that must be satisfied under the performance goal (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, if the terms of the performance goal do not provide for a maximum dollar amount, the formula under which the compensation would be calculated (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 during a specified period.

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

Disclosure of Confidential Information Not Required

The disclosure of a material term of a 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 publicly held corporation. 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 of Shareholder Approval

Once the material terms of a performance goal are disclosed to and approved by shareholders, no additional disclosure or approval is required unless the compensation committee changes the material terms of the performance goal. If, however, the compensation committee has the authority to change the targets under a performance goal after shareholder approval of that goal, the material terms of the performance goal must be disclosed to and re-approved by shareholders no later than 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 acquirer acquires a publicly held corporation with a plan that has already been approved by that corporation's shareholders and the acquirer assumes the plan and extends it to cover some of its own employees, the plan remains subject to the shareholder approval requirement of Section 162(m). There is no need to have the plan reapproved by the acquirer's shareholders as a result of the acquisition.

CERTIFYING ACHIEVEMENT OF PERFORMANCE GOALS

The compensation committee must certify in writing before payment of the compensation that the performance goals and any other material terms were satisfied. 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 value of the stock of the publicly held corporation (for example, compensation paid on the exercise of stock options or SARs).

USE OF NEGATIVE DISCRETION

The compensation committee can use its discretion to reduce or eliminate the compensation that was due to a covered employee on attainment of the performance goal under the formula, but may not increase the compensation. However, the exercise of negative discretion with respect to one employee may not result in an increase in the amount payable 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 that are contingent on the attainment of one or more pre-established, objective performance goals and then reduce those amounts 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 the requirements for performance-based compensation under Section 162(m).

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.

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 a participant his or her 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 meet the following requirements:

- The grant must be awarded by the compensation committee (see Compensation Committee).

- The grant must be made under a plan that specifies the maximum number of shares with respect to options and SARs 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 that the employee may receive under the grant 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 March 30, 2015, the IRS issued final regulations under Section 162(m) (Final 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. The Final Regulations also clarify that plans may satisfy the per-employee limit requirement by specifying the aggregate maximum number of shares with respect to stock options, SARs, restricted stock, RSUs, or other equity-based awards that may be granted to any individual during a specified period. It appears permissible under the Final 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 needs to be contingent on the attainment of a performance goal that satisfies the performance-based compensation requirements. Options that are cancelled or repriced may 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 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 $1 million annual 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 RSU awards are paid currently, without regard to whether the performance goals for the restricted stock and the RSUs (or alternative goals) are satisfied, the payment of dividends and dividend equivalent rights will not cause the restricted stock and the RSUs 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, provided that 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 exercise price and that effectively creates a "discounted" option (which raises issues under Section 409A).

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 the following:

- A change in 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 Code Section 368 (26 U.S.C. 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 Code Section 424(a) (26 U.S.C. 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:

- Compensation that is payable regardless of whether the performance goal is attained on a termination of the covered employee's employment either by the corporation without cause or by the covered employee for good reason or due to the covered employee's retirement.
- Compensation that is paid on the covered employee's death or disability before achievement of the performance goal.
- Compensation that is paid on a change in control before achievement of the performance goal.

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 the following situations:

- The covered employee's employment:
  - is involuntarily terminated by the corporation without cause; or
  - is terminated by the covered employee 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 either by the corporation without cause, or by the executive for good reason or as a result of 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 $1 million annual deduction 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 $1 million annual deduction limit. If, on the other hand, a plan provides for payment on termination of employment 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) will apply.

COMPANIES THAT BECOME PUBLIC COMPANIES

The Act did not make any changes to the special rules under Section 162(m) that apply to compensation paid by private companies that later become publicly held as described in this section. It appears that newly public companies may continue to rely on these special rules subject to further guidance clarifying how the changes made to Section 162(m) by the Act will apply to these companies.

NEWLY PUBLIC COMPANIES

In the case of a corporation that was not a publicly held corporation and then becomes a publicly held corporation, remuneration paid according to a compensation plan or agreement that existed during the period in which the corporation was not publicly held is excluded from the $1 million annual deduction limit. However, in the case of a corporation that becomes publicly held in connection with an initial public offering (IPO), this exception for newly public companies applies only to the extent that the prospectus accompanying the IPO disclosed information concerning those plans or agreements that satisfied all applicable securities laws then in effect. A corporation that is a member of an affiliated group that includes a publicly held corporation is considered publicly held and, therefore, cannot rely on this exception.

This exception may be relied on until the earliest of:

- The expiration of the compensation plan or agreement.
- A material modification of the compensation plan or agreement.
- The issuance of all employer stock or other compensation that has been allocated under the plan.
- For a privately held corporation that becomes publicly held with an IPO, the first shareholder meeting at which directors are to be elected that occurs after the close of the third calendar year following the calendar year in which the IPO occurs.
- For a privately held corporation that becomes publicly held without an IPO, the first shareholder meeting at which directors are to be elected that occurs after the close of the first calendar year following the calendar year in which the corporation becomes publicly held.

Compensation received from the exercise of stock options or SARs, or the vesting of restricted stock, is covered by this rule if the option, SAR, or restricted stock, respectively, was granted before the end of the transition period, regardless of when the award is exercised or vests, as applicable. The Final Regulations provide that this exception does not apply to other forms of equity compensation, such as RSUs or phantom stock. Therefore, effective for awards granted on or after April 1, 2015, RSUs and phantom stock granted during the transition period will be excluded from the $1 million annual deduction limit only if the RSUs or phantom stock are paid out before the transition period expires.

SUBSIDIARIES THAT BECOME PUBLIC

A corporation that is a member of an affiliated group that includes a publicly held corporation is considered publicly held and, therefore, is not permitted to rely on the relief described above for newly public companies (see Newly Public Companies). Instead, if such a subsidiary becomes a separate publicly held corporation (whether by spinoff or otherwise), any compensation paid to covered employees of the new publicly held corporation will satisfy the exception for performance-based compensation if either the "prior establishment and approval" requirements or the "transition period" requirements, each as described below, are satisfied.

Compensation satisfies the "prior establishment and approval" requirements if the applicable requirements for performance-based compensation were satisfied before the subsidiary becomes a publicly held corporation (that is, satisfying the requirements for establishing performance goals, obtaining shareholder approval and obtaining approval by outside directors under Section 162(m)) and the certification of attainment of the performance goals is made by the compensation committee of the new publicly held corporation (but if the performance goals are attained before the subsidiary becomes a separate publicly held corporation, then certification may be made by the compensation committee of the publicly held corporation).

Under the "transition period" requirements, if shareholder approval of the performance-based compensation is not obtained before the spinoff, then shareholder approval will not be required for compensation paid, or stock options, stock appreciation rights, or restricted property granted, before the first regularly scheduled meeting of the shareholders of the new publicly held corporation that occurs more than 12 months after the date the corporation becomes a separate publicly held corporation. Any requirements for performance-based compensation must otherwise be satisfied, provided, that the outside directors of the corporation before it becomes a separate publicly held corporation, or the outside directors of the new publicly held corporation, may establish and administer the performance goals for the covered employees of the new publicly held corporation for purposes of satisfying the requirements for establishing performance goals and obtaining approval by outside directors under Section 162(m). Compensation paid, or stock options, stock appreciation rights, or restricted property granted, on or after the date of that meeting of shareholders that is intended to constitute performance-based compensation must then satisfy all applicable requirements for performance-based compensation under Section 162(m), including the shareholder approval requirement.

LOWER DEDUCTION LIMITS FOR HEALTH INSURANCE PROVIDERS

The Affordable Care Act (ACA) added Section 162(m)(6) to the Code 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.

Not only does the deduction limit apply to compensation paid to covered employees, but it also 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): Limit on Deduction for Compensation Paid by Health Insurers Under the ACA (9-521-2747).

COORDINATION BETWEEN SECTION 162(M) AND SECTION 409A

SHORT-TERM DEFERRALS

Section 409A (26 U.S.C. § 409A) applies to amounts deferred under a "nonqualified deferred compensation plan" which is broadly defined to mean any agreement or arrangement that provides for the deferral of compensation, unless specifically excepted. One commonly relied on exception is the short-term deferral exception which is available for a payment that is generally made no later than 2 ½ months after the first taxable year in which the payment is no longer subject to a substantial risk of forfeiture. 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 (6-501-2009)) that is made after the applicable 2½ month short-term deferral period may continue to qualify as a short-term deferral if the corporation establishes that:

- It reasonably anticipated that the corporation's 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 legally binding 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 corporation anticipates, or reasonably should anticipate, that if the payment were made on that date, the corporation's deduction would no longer 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 corporation reasonably anticipates that if the payment were made as scheduled, the payment would not be deductible under Section 162(m), provided that the payment is delayed until either:

- The covered employee's first taxable year in which the corporation reasonably anticipates, or should reasonably anticipate, that if the payment is made during that year, the deduction of the payment will not be barred by Section 162(m).
- The period beginning with the date of the covered employee's separation from service and ending on the later of:
  - the last day of the taxable year of the corporation in which the covered employee separates from service; or
  - the 15th day of the third month following the covered employee's separation from service.
- If any payment in a corporation's taxable year is delayed under this rule, all scheduled payments to the covered employee that could be delayed in accordance with this rule must be delayed and no election as to the timing of these payments may be provided to the covered employee.

Where the payment is delayed to a date on or after the covered employee's separation from service, the payment is considered a payment made on a separation from service for purposes of Section 409A. Therefore, in the case of a covered employee who is a specified employee**,** the payment must generally be delayed for six months (see Practice Note, Specified Employees Under Section 409A (7-501-1330)).

SECTION 162(M) PROCEDURAL SAFEGUARDS

Compliance with Section 162(m) has been a frequent 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 (especially companies with grandfathered plans that can continue to rely on the performance-based compensation exception) 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).

SECTION 162(M) PLANNING CONSIDERATIONS AFTER THE ACT

Effective for tax years beginning on or after January 1, 2018, companies will have the ability to design pay-for-performance programs without the need to comply with the strict rules of the performance-based compensation exception under Section 162(m) (except to the extent required in respect of grandfathered amounts). For example:

- Performance goals and adjustments will no longer need to be pre-established and objectively determinable, and may be established more than 90 days into the performance period.
- Companies may retain discretion to adjust payouts upwards or downwards based on actual performance (previously, only downward adjustments were permitted).
- Companies will no longer be required to obtain shareholder approval of performance goals every five years.
- Individual award limits under Section 162(m) will no longer be necessary.
- The "plan within a plan" or "umbrella plan" design under Section 162(m) may be eliminated.
- Companies will no longer be limited by the requirement under the performance-based compensation exception for compensation, such as pro rata annual bonuses, to be paid only on achievement of the performance goal in connection with a covered executive's termination of employment either by the company without cause or by the executive for good reason or as a result of retirement.
- Members of the compensation committee will no longer be required to satisfy the definition of "outside directors" under Section 162(m) (but companies should consider the extent to which compliance with independence requirements for compensation committee members under the NYSE and NASDAQ listing standards and the rules under Section 16(b) of the Exchange Act may be required). For more information on these requirements, see Practice Note, Independence Standards: Compensation Committees (8-525-6633).

In addition, companies may consider implementing longer vesting schedules for equity awards or extending the timing for cash payouts of awards or other compensation (such as severance or payments under a supplemental executive retirement plan (SERP) or other nonqualified deferred compensation plan) by spreading the payments over multiple years in an attempt to fit within the annual $1 million threshold under Section 162(m). Companies should be aware that doing so may cause the compensation to become subject to the deferred compensation rules under Section 409A, particularly with respect to severance and other types of post-termination compensation.

Although compensation in excess of $1 million per year will no longer be deductible (even if performance-based), performance-based compensation will remain an important component of executive pay to incentivize executives and respond to the demands of pay-for-performance from shareholders and proxy advisory firms.

For additional practical advice on Section 162(m), including the transition rule, see Article, Expert Q&A on Section 162(m) After Tax Reform (W-013-0488).

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