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Will the $1 Million Cap on Compensation Pose Problems?

by Robert W. Wood • San Francisco

Now that the dust has settled on the Revenue Reconciliation Act of 1993 ("RRA '93"), it is appropriate to take a look at some of the more closely watched provisions of the law. The inclusion of new Section 162(m) was certainly the subject of comment and concern, despite the fact that for many individuals and companies not approaching the magic $1 million dollar mark, the impact may well be more imagined than real. Nonetheless, its inclusion in the bills preceding RRA '93 lead many companies to make large compensation payments in anticipation of the provision's effective date.

Controversial new Section 162(m) disallows a corporation's deduction for compensation to an executive in excess of $1 million during the corporation's tax year. This limitation covers all types of compensation, including cash, property, options, etc. In large part, though, the import–as with so many other tax provisions–is in the numerous exceptions, which are as follows:

1. Compensation paid by a privately held corporation.
2. Compensation paid to executives other than the corporation's top five officers.
3. Compensation deductible in a corporation's tax year beginning before 1994.
4. Performance-based compensation measured according to a pre-established, objective, nondiscretionary formula that meets certain shareholder and independent director approval requirements.

Whether this list makes it obvious or not, the heart of the provision is in the exceptions. But before looking at the exceptions in detail, "compensation" for purposes of the $1 million limit must be defined.

Defining Compensation

"Compensation" includes all cash, stock options, stock, and other forms of payment, but timing issues arise. For example, deferred compensation is generally not taken into account until it is paid; the spread in nonqualified options is generally taken into account at the time of exercise.

The spread in an incentive stock option ("ISO"), on the other hand, is generally included as compensation only if the holder makes a disqualifying disposition of the stock after the exercise of the ISO. Stock subject to Section 83 restrictions is normally treated as compensation on its vesting (the lapsing of the restrictions), unless the holder makes a Section 83(b) election.

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Double Whammy

One easily overlooked question is simply the amount of the deduction limitation. Basically, it is $1 million. But this limit is *reduced* by the amount of any golden parachute payments paid by the corporation to the executive. Since the golden parachute payments are already nondeductible, this reduction can be a real double whammy for corporations that choose to pay such amounts.

Private Company Exception

However, privately held corporations are not subject to the $1 million limitation. For this purpose, the company must be privately held throughout the corporation's taxable year in which the compensation is deductible. A corporation is privately held if it has no class of common equity securities traded on a national securities exchange and does not have both 500 or more holders of a class of common equity securities and $5 million or more of consolidated assets.

This private company definition must be met at all times during the year, even though the compensation might have been paid before a stock issuance that would cause the corporation to go outside the private company definition. Moreover, there is no binding contract exception of any sort, so that a company that enters into a contract to pay compensation for several years in excess of the $1 million mark and then goes public will lose the compensation deduction for the year it goes public and all subsequent years, despite the existence of the binding contract.

The flip side of this issue is how the private company exception should be viewed if a company was publicly held at the beginning of the year, but by the end of the year is privately held within the meaning of this definition. Section 162(m)(2) seems to be clear that the private company definition must be met at *all* times during the tax year, so that the compensation deduction limitation would apply notwithstanding the later private status of the corporation. However, some commentators have already argued that the Service should at least treat a pro rata portion of the compensation paid after private company status is obtained as not being subject to the $1 million limitation.

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Exception for Noncovered Employees

Another exception provides that the $1 million deduction limit does not apply to compensation paid to an executive who is not a "covered employee." This term is defined by Section 162(m)(3) to include the chief executive officer ("CEO") or an individual acting in a CEO-like capacity, as well as the four highest-paid officers other than the CEO whose total compensation for the taxable year must be reported to shareholders under the 1934 Securities & Exchange Commission ("SEC") Act. While these categories of noncovered employees would seem to be clear enough on their face, there are various issues that can arise. For example, while the CEO category refers to the duties of the officer, the determination of the other four individuals is keyed to federal securities law disclosure. That means that the four highest-paid individuals must be determined not according to tax rules, but according to SEC principles.

To be sure, in many companies, the four highest-paid individuals will be easy to determine on any scale. However, there can be differences, because of the presence of options, restricted stock, deferred compensation, and so on. Plus, although it is unusual, a corporation may have a different year for tax purposes than it does for SEC reporting purposes. In such cases, the four highest-paid individuals may be different under these regimes. This can make it difficult to figure out just who is a "covered employee" as of any particular moment.

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When compensation is earned by the executive and when it is deductible, of course, are two different questions, and it is the time of deduction that is important for purposes of determining who the noncovered employees are. Compensation (*e.g.*, deferred compensation, restricted stock, phantom stock, etc.) may be earned by an executive while he or she is a covered employee, but he or she may not be a covered employee at the time the compensation is actually paid. The time of payment, or more precisely, the time of the deduction (which, in the cases mentioned, would be simultaneous) is the point at which the status of the person as a covered or a noncovered employee becomes relevant. As long as the individual is a noncovered employee at the time of payment, the $1 million limitation would not apply.

Performance-Based Compensation

The rule that performance-based compensation is not subject to the $1 million cap may appear to be a door that is larger than a house. After all, virtually every company espouses the notion that its compensation is performance-driven. To qualify for this exclusion, however, each of the following tests must be met:

1. The compensation must be payable solely on account of attaining one or more nondiscretionary objective performance goals.
2. The performance goal must be determined by an independent compensation committee of the board comprised solely of two or more outside directors.
3. The material terms under which the compensation is to be paid (including the performance goals) must be disclosed to shareholders and approved by a separate majority shareholder vote.
4. Before the compensation is paid, the independent compensation committee of the board must certify that the performance goals and any other terms were satisfied.

Grandfathered Compensation

Although it does not present interesting technical issues, one of the more significant exceptions, at least for the short run, is the grandfather rule. The $1 million limit does not apply to compensation payable under a binding written contract in effect on 2/17/93 and not modified thereafter in any material respect. Even renewals after that date will trigger the deduction limit. Apart from the grandfather rule, the deduction limit does not kick in for any taxable year beginning before 1994.

Acquisitions Affected

Although Section 162(m) can hardly be called a provision dealing with corporate acquisitions, the fact remains that the $1 million cap will have to be taken into account in the context of acquisitions, and some of the effects of the provision may be unanticipated.

For example, the acquisition may actually produce a short taxable year for the acquired company that will in effect water down the $1 million limit, because the statute does not annualize the $1 million cap in the case of short taxable years. The main question that will arise is: who are the covered and noncovered employees of the respective companies in an acquisition? As noted above, the answer is determined solely by the federal securities laws. It will be some time before the impact of the compensation deduction limit and its various exceptions are tested and explored. We will keep you apprised of developments as they occur. ■

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