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Executive Compensation Limitation Regs Finalized

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Final regulations (T.D. 8650) have been published under Section 162(m) concerning the disallowance of deductions for employee remuneration in excess of $1 million. The first set of proposed regulations were issued under Section 162(m) back in December of 1993 (58 Fed. Reg. 66310). A year later, the Service issued another batch of proposed regs that made a variety of ameliorative changes.

Now, the final regulations give further clarification in a variety of important areas. Some of the more important items include:

- The treatment of bonus pools to be spread among executives;
- Companies that become public through nonpublic offerings; and
- The lapsing of transitional rules.

Background of Section 162(m) Restrictions

Under Section 162(m) of the Code, a publicly held corporation is denied a deduction for compensation paid to "covered employees" to the extent the compensation exceeds $1 million. A "covered employee" includes the Chief Executive Officer, plus any other individual whose compensation is required to be reported to the SEC by reason of that individual being among the four highest compensated officers (other than the CEO) for the taxable year. This calculation is measured as of the end of the corporation's tax year.

One of the most important features of Section 162(m) is that so-called performance-based compensation is not subject to the deduction limitations. In general, performance-based compensation

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is remuneration that is payable solely on account of the attainment of one or more performance goals, but only if:

1. Goals are determined by a compensation committee of the board of directors consisting solely of two or more outside directors;
2. The material terms under which the compensation is to be paid are disclosed to the shareholders and approved by a majority of the compensation committee in a separate vote before payment is made; and
3. Before any payment is made, the compensation committee certifies that the performance goals and any other material terms have been satisfied.

Another major exception—although of limited prospective utility—is the rule that compensation is excluded from the $1 million limitation if it is paid under a binding written contract that was in existence on February 17, 1993. The proposed regulations issued in 1993 had exempted from the limitation compensation paid under an arrangement that existed before the corporation became publicly held, as long as the arrangement is disclosed as part of the initial public offering.

Final Regulations

Among the principal changes made in the final regulations are various modifications to the performance-based rules. For example, the proposed regulations had provided that the rule for performance-based compensation generally applied on a grant-by-grant basis. However, if the facts and circumstances indicated that the employee would receive all or a part of the compensation regardless of whether the performance goal is attained, compensation was not deemed to be performance-based.

Commentators to the proposed regulations questioned whether nonperformance-based dividend equivalents that are paid with respect to a granted but unexercised stock option (irrespective of whether the option is ever actually exercised) will cause the compensation paid upon the exercise of the option to be considered nonperformance-based. Generally speaking, companies will want compensation to be deemed to be performance-based precisely because then that compensation will be outside of the $1 million cap.

Fortunately, the final regulations now provide that such dividend equivalents will not cause the compensation paid upon the exercise of the option to be considered nonperformance-based, as long as the payment of the dividend equivalents is not conditioned upon the employee exercising the option. Reg. §1.162-27(e)(2)(vi). If the payment of the dividend equivalent is conditioned upon the employee exercising the option, on the other hand, the dividend effectively will reduce the exercise price of the option, thereby causing the option to be considered nonperformance-based upon its exercise.

The final regulations also address bonus pools, another topic that is of relevance in determining whether compensation is performance-based (and therefore outside the $1 million per executive cap). Under the proposed regulations, a pre-established performance goal must state (in an objective formula or standard) the method for computing the amount of compensation payable to the employee if the goal is attained. Prop. Reg. §1.162-27(e)(2)(ii). A formula or standard is considered objective if a third party having knowledge of the relevant performance results could calculate the amount to be paid to the employee.

The final regulations responded to comments to the effect that compensation committees may state an amount payable to each individual under a bonus

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pool plan as a percentage of the bonus pool, and that the total of these percentages may even exceed 100% of the pool. The use of such overlapping percentages would be inconsistent with the rules set forth in the proposed regulations. Accordingly, the final regulations state that when the compensation to be paid to each employee is stated in terms of a percentage of a bonus pool, the sum of the individual percentages for all participants in the pool cannot exceed 100%.

Furthermore, the exercise of negative discretion with respect to one employee cannot increase the amount payable to another employee. While the preamble to the final regulations indicates that this is not intended as a substantive change, the IRS has recognized that there is a difference of opinion on this point. Consequently, this clarified rule (regarding negative discretion and bonus pools) is not to apply to any compensation paid before January 1, 2001 under a bonus pool based on performance in any period that began before December 20, 1995.

Outside Directors

The final regulations also make a clarifying change with respect to outside directors, a topic that is important in assessing the make-up of the compensation committee. A director is not precluded from being considered an outside director solely because he or she is a former officer of a corporation that previously was an affiliated corporation of the publicly held entity. The final regulations now clarify that a former officer of either a spun-off or liquidated corporation (that formerly was a member of the affiliated group) is not precluded from serving on the compensation committee of the publicly held member of the affiliated group.

Companies that Become Publicly Held Without an IPO

The $1 million per executive limitation of Section 162(m) applies only to publicly held corporations. Consequently, it is important both to determine what is a publicly held entity and also to review the rules for companies that transition between public and private ownership. The $1 million deduction limitation does not apply in the case of any compensation plan or agreement that existed before the corporation became publicly held, as long as the plan or agreement was disclosed in the prospectus accompanying the initial public offering. Reg. §1.162-27(f).

This exception is important, but nonetheless can generate substantial concern on the part of those involved in the IPO as to the nature of the disclosure. Interestingly, there is a time limit on even this exception. It may be relied upon only until the earliest of:

- the expiration of the plan or agreement relating to the compensation;
- the material modification of the plan or agreement;
- the issuance of all stock and other compensation that has been allocated under the plan; or
- the first shareholder meeting at which directors will be elected that occurs after the close of the third calendar year following the calendar year in which the IPO occurs.

The theory of the rule that Section 162(m) should not apply in the case of disclosures pursuant to IPOs seems to be that the disclosure itself essentially amounts to a favorable vote on the compensation arrangement by shareholders. That, in effect, is intended to import fairness. After all, the disclosure can be a painful one, particularly if the numbers are high.

When a corporation goes public without an IPO, there is seemingly no alternative. However, the final regulations now recognize that there should be relief for privately held corporations that become publicly held without an IPO. Accordingly, the final regulations now allow reliance on a transitional rule (protecting the corporation from the nondeductibility of Section 162(m)).

The relief provided by going public without an IPO is only temporary though. The transitional rule lapses upon the first meeting of shareholders 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. Reg. §1.162-27(f)(1).

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Written Binding Contracts

There is another transitional rule in the final regulations for compensation payable under written binding contracts. The proposed rules provided that a written binding contract that was terminable or cancelable by the corporation after February 17, 1993 without the employee's consent would be treated as a new contract as of the date that any such termination or cancellation (if made) would be effective. Furthermore, the proposed rules indicated that if the terms of a contract provided that the contract would be terminated or canceled as of a certain date unless either the corporation or the employee elects to renew within thirty days of that date, the contract would be treated as renewed by the corporation as of that date.

The final regulations suggest that the IRS believes that whether a contract is binding should be determined based upon whether the *corporation* is bound.

Example

Suppose a contract provides the employee with a right to extend or renew the terms of the employment contract without the consent of the corporation. The corporation is legally obligated to pay the agreed upon compensation to the employee if he or she chooses to extend or renew the contract. In this case, the contract will be considered binding on the corporation.

The regulations have therefore been clarified to state that if the corporation will remain legally obligated by the terms of a contract beyond a certain date at the sole discretion of the employee, the contract will not be treated as a new contract as of that date if the employee exercises the right or discretion in question. Reg. §1.162-27(h)(1)(i).

Subsidiaries that Become Separate Publicly Held Corporations

Another facet of the limitation on deductibility of compensation provided by Section 162(m) is definitional. Precisely what is a separate public company. The proposed regulations had already provided special rules for subsidiaries that become separate publicly held corporations. See Reg. §1.162-27(f)(4). The final regulations now indicate that compensation paid prior to the delayed effective dates by a subsidiary that becomes a separate publicly held corporation will not be subject to the $1 million deduction limitation if the conditions of the transi-tional rule are satisfied. The transitional rule is set forth in Section 1.162-27(l)(2)(iii) of the regulations. ■