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MEMORANDUM

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Performance-Based Compensation Under IRC § 162(m)

Section 162(m) of the Internal Revenue Code limits to $1 million a publicly-traded company's deduction for compensation paid to any covered employee[1] in a single year. However, certain "performance-based compensation" is exempt from the $1 million limit. Summarized below are some of the key requirements for "performance-based compensation" under § 162(m) and the related regulations.

I. General Requirements[2]

Regulations under § 162(m) provide that compensation will be considered "performance-based" only if:

(1) the compensation is payable solely on account of performance goals having been satisfied;

(2) the performance goals are set by a compensation committee consisting solely of two or more outside directors and are pre-established and objective;

(3) the method of computing the compensation payable upon satisfaction of the performance goals is stated in an objective formula;

(4) the objective formula precludes discretion to increase the amount payable upon satisfaction of the goal;

(5) the material terms of the performance goals are approved by shareholders before the compensation is paid; and

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1 Generally, the CEO and four other most highly paid officers of the company.

2 This memorandum does not address the special rules under which options and SARs will be treated as performance-based compensation.

(6) before the compensation is paid, the compensation committee certifies in writing that the performance goals have been satisfied.

Additional information is provided below on the establishment of performance goals by a compensation committee and shareholder approval of the material terms of such goals.

II. Establishment of Performance Goals By Compensation Committee

A. Timing of Committee Action

Under the regulations, a performance goal is considered preestablished if it is approved in writing by the compensation committee not later than 90 days after the commencement of the period of service to which the performance goal relates, provided that the outcome is substantially uncertain at the time of establishment. However, in no event will a performance goal be considered preestablished if it is approved by the committee after 25% of the relevant period of service has elapsed. Thus, the IRS has stated that performance goals must be established by the earlier of (1) 90 days after the commencement of the service period or (2) the date when 25% of the service period has elapsed. PLR 9601032 (Jan. 5, 1996).

B. Performance Goals Described

A compensation committee may establish performance goals based on one or more business criteria that apply to the individual, a business unit, or the corporation as a whole. The regulations provide that such business criteria could include, for example, stock price, market share, sales, earnings per share, return on equity, or costs.

Typically, a performance goal would be based on an increase in a business criterion (e.g., 10% increase in sales). However, the regulations provide that a performance goal does not need to be based on an increase or positive result and could include, for example, maintaining the status quo or limiting the decrease in a business criterion. The regulations make clear that a performance goal does not include the mere continued employment of an employee. Thus, an award that vested based solely on continued employment would not qualify as performance-based compensation.

An noted above, a performance goal must be objective. The regulations provide that a goal is objective if a third party having knowledge of the relevant facts could determine whether the goal is met.

III. Approval By Shareholders

Under the regulations, the material terms of a performance goal under which the compensation is to be paid must be disclosed to and approved by the shareholders of a company before the compensation is paid. The shareholder approval requirement is not satisfied if the compensation would be paid regardless of whether the material terms are approved by the shareholders.

A. Material Terms to Be Approved

The material terms of a performance goal to be approved by shareholders include the following:

- The employees eligible to receive compensation.

  The regulations provide that "a general description of the class of eligible employees by title or class is sufficient, such as the chief executive officer and vice presidents, or all salaried employees, all executive officers, or all key employees."

- A description of the business criteria on which the performance goal is based.

  The regulations provide that "disclosure of the business criteria on which the performance goal is based need not include the specific targets that must be satisfied under the performance goal. For example, if a bonus plan provides that a bonus will be paid if earnings per share increase by 10 percent, the 10-percent figure is a target that need not be disclosed to shareholders. However, in that case, disclosure must be made that the bonus plan is based on an earnings-per-share business criterion."

- Either the maximum amount of compensation that could be paid to any employee during a specified period or the formula used to calculate the amount of compensation to be paid to the employee if the performance goal is attained.

B. Timing of Approval

As noted above, shareholder approval of the material terms of a performance goal must occur "before the compensation is paid." The regulations do not address how this requirement applies to awards of stock options and other stock-based awards with vesting provisions. In this context, it would seem reasonable to conclude that shareholder approval occurs before compensation is paid if the approval occurs before the award vests or becomes taxable to the employee.

The regulations also provide that, once the material terms of a performance goal have been approved by shareholders, no additional 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 the goal, the material terms of the performance goal must be re-approved by shareholders no later than the first shareholder meeting that occurs in the fifth year following the year in which shareholders previously approved the performance goal. Because companies typically only have shareholders approve the general business criteria (e.g., earnings per share, sales) upon which the compensation committee sets specific performance goals, shareholder approval of the criteria every five years is normally required.