

TAX ALERT

IRS TO FOCUS ON EXECUTIVE COMPENSATION; COMPENSATION COMMITTEES SHOULD REVIEW APPROVAL PROCEDURES FOR PERFORMANCE-BASED COMPENSATION

Senior Internal Revenue Service (IRS) officials have indicated in recent speeches that the tax treatment of executive compensation is one of the areas on which the Service will be focusing its examination priorities.¹ One area that may be the subject of IRS review is the certification process that compensation committees of public companies must follow in order for performance-based incentive compensation to be exempt from the \$1 million compensation deduction limit under Section 162(m) of the Internal Revenue Code of 1986, as amended. Certification procedures may be particularly subject to review in the coming year, as many companies may revise their compensation policies if the Securities and Exchange Commission adopts proposed rules that will require companies to disclose in their proxy statements the extent to which their compensation policies contribute to risk-taking by executives where those policies may have a material effect on the company. In view of this heightened focus on executive compensation, compensation committees serving public corporations should re-examine their basic procedures for certification and payment of amounts earned under performance-based incentive plans.

Section 162(m) denies a publicly held corporation a tax deduction for compensation paid to a “covered employee”² during a taxable year in excess of \$1 million,³ unless such compensation meets certain specified exceptions. The most significant exception to the compensation deduction cap provides that “qualified performance-based compensation” will not be subject to the \$1 million limitation. In general, performance-based compensation is compensation paid solely on account of the attainment of pre-established performance goals that are set forth in terms of an objective compensation formula that precludes discretion to increase the amount of compensation payable upon attainment of the goal or target. The performance-based compensation goals must be established by a compensation committee of the board of directors comprised solely of two or more outside directors, and the material terms of the compensation program and the performance goals must be disclosed to

¹ See, e.g., remarks by Faris Fink, Deputy Commissioner of Internal Revenue Service’s Small Business/Self-Employed Operating Division, at a tax conference hosted by New York University, reported in *BNA Daily Tax Report*, Thursday, October 22, 2009, at page G-10.

² A “covered employee” includes the chief executive officer and the public corporation’s three most highly compensated officers employed as of the last day of the corporation’s taxable year (other than its chief executive officer and chief financial officer), whose compensation is required to be reported to shareholders at the end of such taxable year under the Securities and Exchange Commission’s compensation disclosure rules under Item 402 of Regulation S-K.

³ The compensation cap is \$500,000 for certain covered executives employed by entities participating in the Troubled Assets Relief Program.

shareholders and approved by a majority of the vote in a separate shareholder vote. In addition, before the payment of any such compensation, the compensation committee must certify that the performance goals and any other material terms of the incentive were, in fact, satisfied.

Under Treasury regulations, there are two ways of satisfying the certification prior to payment requirement. The first way is by a written certification. The second way is by approval of minutes certifying the extent to which the milestones were achieved. Treasury regulations under Section 162(m) require that “[t]he compensation committee must certify in writing prior to payment of the compensation that the performance goals and any other material terms were in fact satisfied. For this purpose, approved minutes of the compensation committee meeting in which the certification is made are treated as written certification.” However, the regulations provide that the minutes must be approved prior to the time the actual payments are made.

The regulation’s requirement of approved minutes in lieu of a written certification creates a concern that the IRS may view compensation paid out prior to the approval of the minutes as violating the Section 162(m) requirements for the performance-based compensation exception. In preparation for increased scrutiny of executive compensation administrative practices, compensation committees of public corporations should consider adoption of one or more of the following certification procedures—

- Have the compensation committee sign a written certification that the performance goals were attained and approve the performance-based payments in writing for purposes of Section 162(m) prior to payment.
- Draft the portion of the minutes of the meeting relating to certification of performance-based payments for purposes of Section 162(m) and include the draft in the meeting materials. The committee would then be asked to approve these draft minutes at the telephonic or in-person meeting.
- Have the compensation committee approve the performance-based payments at a telephonic or in-person meeting and authorize the chairman of the committee to sign a written certification prior to payment.
- Delay payments under the performance-based compensation plan until after the compensation committee formally approves the minutes of the committee meeting approving the payments. Care should be taken to avoid a delay that will cause the compensation to be paid beyond the two-and-a-half-month short-term deferral period. Such a delay could result in the compensation being treated as deferred compensation and could result in the deduction being delayed to a subsequent taxable year.

Certification by the compensation committee is not required for compensation that is attributable solely to increases in value of the stock of a public corporation. Although the procedures suggested above may appear to be conservative interpretations of the requirements, they are prudent practices to ensure the deductibility of performance-based executive compensation.

CONTACT INFORMATION

If you have any questions regarding this alert, the information required to be reported under the new final regulations, or other executive compensation or employee benefits issues, please contact—

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