

# Executive Compensation and Benefits Memo

## Continued Viability of Discretionary Incentive Compensation

February 5, 2007

In the past few weeks, some of our clients have asked us about the continued viability of incentive compensation arrangements for executives where the compensation committee exercises discretion *at the end of the performance period* to determine the payment amounts. Our clients' concerns have arisen because of (1) reports of increased attention being focused on these arrangements in IRS audits; (2) greater detail about these arrangements that must be disclosed because of the new SEC proxy disclosure rules; and (3) media criticism of such arrangements. This memorandum briefly discusses the tax and SEC status of these arrangements and concludes that such arrangements remain viable.

### IRS Audits and the \$1 Million Limit

Annual compensation received by the CEO and each of the four other highest paid officers of a public company is not tax deductible by the company to the extent that it exceeds \$1 million. However, amounts that qualify as "performance-based compensation" are exempt from this limit. Apart from stock options and stock appreciation rights, which are subject to special rules, an amount will be considered performance-based compensation exempt from the limit only if, among other things, payment is contingent upon the attainment of objective performance goals that are established at the beginning of the performance period, and attainment of the goals is substantially uncertain when the goals are established. Compensation will not satisfy this requirement if payment can be made even if the pre-established performance goals are not attained. For example, an arrangement will not satisfy the performance-based compensation requirements if the compensation committee, in its discretion, may relax the goals at the end of the performance period or if the committee retains discretion to increase the amount of compensation payable. However, an amount will not fail to be performance-based compensation if the amount payable upon achievement of the performance goal may be *reduced* in the discretion of the compensation committee.

### Typical Arrangement

Companies sometimes use the following performance-based compensation arrangement to satisfy the prohibition on discretionary benefit increases made at the end of the performance period, while allowing the compensation committee greater control over the amount of the payment. The arrangement provides for a specified payment to be made upon satisfaction of a pre-established objective performance goal, and reserves to the compensation committee the discretionary authority to reduce the amount of payment at the end of the period. Usually, the arrangement provides that the amount to be earned by reason of the satisfaction of the pre-established objective performance goals is greater than the amount the committee in fact expects to approve. At the end of the performance period, the committee determines the appropriate amount of the payment based on factors it determines to be pertinent, including circumstances that have arisen during the performance period. The committee then adjusts the payment to that amount, by exercising its discretion to *reduce* the amount that was earned by reason of satisfying the pre-established objective performance goal.

### IRS Audit Activity

We understand that, increasingly, IRS agents have been challenging the characterization of performance-based compensation when auditing employers. It appears that, in some cases, particular attention is being focused on arrangements under which the compensation committee expects to exercise discretion at the end of the performance period to reduce the amount otherwise payable under the arrangement (such as those described above).

Over the past several months, the IRS has significantly expanded the attention given to executive compensation on audit, and this has included a greater focus on performance-based compensation. However, the increased attention appears to be the result of an IRS determination in the past several months that there has been significant general non-compliance with the

tax rules that apply to executive compensation. The attention does not reflect a change to the performance-based compensation regulations. Those rules, which have not changed in several years, expressly permit the use of discretion to reduce the amount of performance awards.

In an effort to better understand the IRS position, we spoke with senior IRS representatives about incentive arrangements that permit discretionary reductions in the awards at the end of the performance period. According to those conversations, there has been no change in the IRS's view that the use of discretion is permissible, and the actions being taken by these auditors do not reflect a shift in IRS policy with respect to such discretionary adjustments.

## **Securities Rules – Executive Compensation Disclosure**

Under SEC executive compensation disclosure rules that are effective for proxy statements distributed after 2006, the summary compensation table is to include a column for non-equity incentive compensation and a column for bonuses. Amounts should be reported as “non-equity incentive compensation” if payment is based on achievement of performance targets, the outcome is substantially uncertain at the time the targets are established, and the targets are communicated to the affected officers. However, if incentive compensation is based on a target that is not pre-established or communicated to officers, or if the outcome is not substantially uncertain at the time the target is established, the compensation should instead be reported as a “bonus.”

The SEC proxy disclosure rules do not themselves indicate how to characterize an arrangement that provides for payment of a specified amount upon achievement of a pre-established performance goal, where the compensation committee has retained the discretion to reduce the amount of the payment at the end of the performance period. However, in Frequently Asked Questions issued January 24, 2007, the SEC indicated that payments that otherwise meets the definition of a “non-equity incentive plan,” but permit the exercise of discretion to reduce “the amounts of the bonuses, generally would still be reportable in the ‘Non-equity Incentive Plan Compensation column.’”

Generally, the performance targets taken into account in determining the amount of incentive compensation must be disclosed in the proxy statement. We have received questions as to which factors must be disclosed for incentive compensation

arrangements that permit the use of compensation committee discretion to reduce the amount of the award at the end of the performance period. We believe that, in most cases, it would be reasonable to interpret the SEC rules as imposing an obligation to disclose both the pre-established goals and the factors taken into consideration when the adjustments are made.

If the targets and other factors used in determining the amount of the incentive payments involve certain confidential information, and their disclosure would result in competitive harm for the issuer, the targets need not be disclosed. However, if such disclosure is not made, the proxy statement must instead indicate how difficult it will be to achieve those targets, or how likely their achievement will be. In describing the level of difficulty with respect to payments intended to be “performance-based compensation” exempt from the \$1 million limit, the company should bear in mind not only that the disclosure must be accurate, but also that the program will satisfy the requirements for performance-based compensation exempt from the \$1 million limit only if achievement of the goals is substantially uncertain at the time the goals are established.

## **Conclusion**

In our experience, compensation committees are focusing greater attention on the use of pre-established objective performance goals for executive incentive compensation arrangements. In many cases, however, compensation committees have decided to retain discretion to adjust the amount of incentive compensation at the end of the performance period. This decision has been made, notwithstanding media comments, out of the committee's desire to avoid inappropriately rewarding or penalizing executives based on circumstances that were not foreseeable at the beginning of the performance period. We believe that such arrangements, if properly structured and administered, should satisfy the applicable tax requirements while complying with the SEC disclosure rules, and should remain viable.

If you have any questions regarding this topic, we would be pleased to discuss them with you. For more information, please contact any of the attorneys listed on the following page. If you did not receive this *Executive Compensation and Benefits Memo* directly but would like to do so in the future, please send your e-mail address to [mnoonan@mayerbrownrowe.com](mailto:mnoonan@mayerbrownrowe.com).

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