Umbrella Bonus Pool Design—Enhancing Flexibility While Preserving Tax Deductibility

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Introduction

Is your company taking full advantage of the tax laws regarding deductible compensation under Internal Revenue Code Section 162(m)? When it comes to deducting executive bonus payments, many are not. Under current tax rules, a publicly-held company may not deduct "non-performance based compensation" paid to certain executive officers in excess of $1 million. However, if a company's incentive plans and programs are designed properly, the portion of an executive's compensation that is considered non-deductible under the tax rules can be minimized or even eliminated, helping to decrease the company's overall tax burden.

Although these loss of tax-deductibility rules apply to a small number of company executives (i.e., generally, those named in the annual proxy statement), because it pertains to top company executives, this issue has generated significant attention, and plaintiffs' lawyers via derivative lawsuits, and the IRS through renewed scrutiny in this area, have made this a new target for attack.

Think This Does Not Apply to Your Annual Bonus Plan?—Consider These Situations

There are several fact patterns that give rise to potentially non-deductible annual bonus payments (i.e., payment of non-performance based compensation). These include the following:

- **Use of a Subjective Performance Metric as a Stand-Alone Performance Goal**—Many annual bonus plan designs incorporate a specified "mix" of financial and non-financial/personal goals to evaluate executive performance (e.g., 80% of bonus based on financial goals and 20% of bonus based on personal goals). Generally, this use of subjective performance goals (such as personal/individual goals) will cause the entire bonus to be considered non-performance based compensation and, therefore, subject to the $1 million cap on tax deductibility.

- **Use of a Subjective Performance "Modifier"**—Some annual bonus plans provide that the formulaic bonus amount determined by the level of achievement of the financial performance goals may be "modified" (either positively or negatively) based on the Compensation Committee's assessment of each executive's non-financial personal goals. The use of positive discretion to increase an annual bonus payout generally will cause the resulting payout to be subject to the $1 million cap.

- **Adjustment of Plan Results for Mid-Year Acquisitions and Non-Recurring Items**—Some annual bonus plans provide that the Compensation Committee may adjust bonus goals or performance results in response to extraordinary, unanticipated, or nonrecurring events. If the Compensation Committee's authority to make adjustments is not properly structured and designed, then any such adjustment will cause the bonus award to be considered non-performance based compensation, and, again, may not be tax deductible by the company.

- **Committee's Use of Discretion to Increase Bonus Payout**—Some Compensation Committees use discretion to determine the annual bonus payouts, based solely on the Committee members' subjective evaluation of company and executive performance. As a general matter, bonus awards based on the discretion of the Compensation Committee will be considered non-performance based compensation subject to the $1 million cap.

Given that these fairly common design features can negatively impact the potential tax deductibility of annual bonus payouts, the remainder of this article presents a fairly simple bonus structure that allows for enhanced flexibility through the use of subjective measures and complete Committee discretion, yet is designed to preserve full tax deductibility.

Overview of IRC Section 162(m)

Although a detailed review of the technical requirements of Internal Revenue Code (IRC) Section 162(m) is beyond the scope of this article, a high-level description of the rule is provided for reference.

The Basic Rule

In very general terms, Section 162(m) provides that no publicly held corporation will be allowed a tax deduction for compensation paid to any "covered employee" if the amount of the compensation to the covered employee for the taxable year exceeds $1 million. For purposes of applying this rule, the term "covered employee" generally refers only to the named executive officers of the company as set forth in the annual proxy statement (note, however, that the chief financial officer is excluded from the rules of Section 162(m) due to a legislative glitch with the interplay between the proxy disclosure rules and the IRC Section 162(m) rules).

In addition, there are certain types of compensation that are specifically exempt from the rules of Section 162(m), including "qualified performance-based compensation." For example, although base salary is never performance-based, stock options in most all cases qualify for this "performance-based" exception.

If compensation is considered to be "qualified performance-based compensation" under Section 162(m), then even amounts paid that are in excess of $1 million will be tax deductible by the company if the payments qualify for this exemption. Therefore, the goal is to structure as much compensation as possible to be considered "qualified performance-based compensation".

Qualified Performance-Based Compensation

There are several requirements that must be met for compensation to be considered "qualified performance-based compensation". Generally, these requirements include:

- **Attainment of Performance Goal**—Compensation must be paid solely on account of the attainment of one or more pre-established, ***objective*** performance goals that ***preclude upward or positive discretion*** to increase the award size.

- **Establishment by Compensation Committee**—The objective performance goals must be formally established by a Compensation Committee comprised solely of two or more "outside directors", generally during the first 90 days of the performance period.

- **Shareholder Approval**—The material terms of the performance goal must be disclosed to and approved by shareholders before the compensation is paid, including the maximum amount payable in a given year to any one participant.

- **Compensation Committee Certification**—Prior to payment, the Compensation Committee must certify in writing that the performance goals were attained.

The so-called “umbrella bonus pool” design is one method to meet all of these requirements, and, thereby, to characterize annual bonus payments (to covered employees) as qualified performance-based compensation.

Overview of Umbrella Bonus Pool

An umbrella bonus pool (known by some as “the plan within a plan”) operates above a company’s normal incentive plan, also called the “underlying plan”. The umbrella bonus pool approach must satisfy all of the requirements discussed above to be considered qualified performance-based compensation. The underlying plan may be a discretionary bonus plan, a traditional incentive arrangement (e.g., targets based on percentage of base salary with threshold, target, and maximum payout opportunities), or time-based restricted stock or restricted stock units. Generally, the underlying plans normally would not qualify as performance-based compensation in their own right, typically because: (i) the Compensation Committee retains discretion to adjust awards upward, (ii) the underlying plan includes the use of subjective/individual performance measures, or (iii) the compensation payable is not based solely on the increase in the value of the stock (e.g., restricted stock).

In further support of the use of this bonus pool design, the IRS, in its final regulations under Section 162(m), has approved the use of umbrella bonus pools provided the following additional requirements are met:

- The exercise of negative discretion, with respect to one covered employee, does not result in an increase in the amount payable to another covered employee; and

- The sum of each covered employee’s allocable share of the bonus pool does not exceed 100 percent.

Establishing an Umbrella Bonus Pool

To comply with IRC Section 162(m), an umbrella bonus pool must be established pursuant to a shareholder approved plan. The “mechanics” of the shareholder approved plan generally fall into one of two categories:

1. **“Hard Coded” Bonus Pool Formula.** The plan document provides for a “hard coded” bonus pool formula within the plan document (i.e., 2% of Operating Income); or

2. **Laundry List Approach.** The plan document provides for a “laundry list” of various “traditional” (i.e., it is clear how the measure is computed) performance metrics from which the Compensation Committee may choose from and establish the bonus pool via committee resolution. Each of these approaches is discussed in more detail below.

1. “Hard Coded” Bonus Pool Formula

Some companies choose to have shareholders approve the specific compensation formula (within the plan document) for determining a fixed bonus pool (e.g., 2% of Operating Income) amount that can be paid to employees designated for participation each year (e.g., those expected to be named executive officers in the next annual proxy statement). The compensation formula is used to calculate the maximum aggregate pool and the percentage of the pool that can be paid to any named participant for that plan year. The Compensation Committee then uses negative discretion to adjust the awards down to what would be paid according to the underlying incentive plan. If the specific bonus pool formula is disclosed within the plan document and approved by shareholders, the plan does not need to be reapproved by shareholders every five years (i.e., the plan can continue on until formally terminated by the Compensation Committee). Avoiding repeated shareholder approval requirements is an important advantage of this approach. However, there are disadvantages with this approach. For example, if the bonus pool falls short due to company performance, or if the company decides to change the compensation formula, shareholder approval must be sought.

2. Laundry List Approach

The other approach involves shareholders approving a plan document that includes a “laundry list” of performance measures and a maximum incentive award amount that can be paid to any individual. Generally, the shareholder approved individual maximum set forth in the plan document is larger than the maximum amount that could be awarded to the individual pursuant to the underlying plan. The Compensation Committee then establishes, pursuant to a written resolution, the bonus pool formula using one of the shareholder approved measures contained in the plan document, within the first 90 days of the beginning of the performance period. (***Note:*** *The measure and achievement level can change every year as long as it is one of the measures on the laundry list.*) The bonus pool formula is also established at a level that can provide for the payment of an amount to each covered employee that is higher than the possible maximum bonus that would be awarded pursuant to the underlying plan. However, the amount paid pursuant to the bonus pool formula cannot exceed the individual maximum disclosed to and approved by shareholders. The Compensation Committee then uses negative discretion to adjust the awards determined under the bonus pool formula down to what would be paid according to the underlying incentive plan. Unlike the “hard coded” bonus pool formula, this “laundry list” of performance measures must be reapproved by shareholders every five years.

Mechanics of an Umbrella Bonus Pool

No matter which plan document approach is used (i.e., the hard coded bonus pool formula, or the laundry list approach), the mechanics of an umbrella bonus pool are the same. As the following example illustrates, the proposed pool amount is determined and allocated among the top six executive officers (i.e., those officers expected to be named in the annual proxy statement for that year) as follows:

FY2012 Planned Operating Income: $400 million Pool Allocation: 2% Resulting Incentive Pool: $8 million			
Executive Name	**Executive Title**	**% of Pool Allocated**	**Maximum Bonus to Executive Under the Pool**
A	CEO	40%	$3.20 million
B	COO	20%	$1.60 million
C	General Counsel	10%	$800,000
D	BU President	10%	$800,000
E	BU President	10%	$800,000
F	EVP	10%	$800,000

Underlying Incentive Plan—Key Features

Meanwhile, the operational bonus plan runs under the umbrella plan, as follows (note, as long as bonus amounts determined under the regular operating plan are less than the amounts computed under the umbrella pool plan, all bonus amounts will be exempt as being “performance-based” under IRC Section 162(m)).

- **Eligible employees:** The CEO and the five or so other executive officers, who have the most likelihood of being a named executive officer in the proxy for that year.

- **Performance goals and payout levels:** The underlying incentive plan contains predetermined performance goals and related target payout levels. Each covered employee may receive up to a maximum of 200% of their respective target bonus payout based on achieved performance levels. In addition, payout levels may be adjusted up or down by an individual modifier that relates to the achievement of subjective goals (e.g., individual performance goals). Target performance payout levels and maximum payout levels of the underlying incentive plan are described below:

Executive	Base Pay	Target Bonus Opportunity	Target Payout Amount	Maximum Payout Amount
A	$1,000,000	100%	$1,000,000	$2,000,000
B	$600,000	80%	$480,000	$960,000
C	$500,000	70%	$350,000	$700,000
D	$500,000	70%	$350,000	$700,000
E	$500,000	70%	$350,000	$700,000
F	$500,000	70%	$350,000	$700,000

- **Award determination:** At the conclusion of the performance year, the Compensation Committee determines the extent to which performance goals have been achieved and the related payout amount pursuant to the underlying incentive plan. The Compensation Committee has the discretion to increase or decrease the payout amount based on an individual modifier that solely considers subjective performance goals.

- **Status of bonus payments under Section 162(m) without an umbrella bonus pool:** Absent the use of an umbrella bonus pool (as described below), any bonus payments made under the annual incentive plan would not constitute qualified performance-based compensation under Section 162(m) because the Compensation Committee may exercise discretion to increase award amounts. Therefore, any award paid pursuant to the underlying incentive plan would count against the $1 million deduction limitation.

- **Status of bonus payments under Section 162(m) with an umbrella bonus pool:** Utilizing an umbrella bonus pool to fund award payments made under the annual incentive plan would change the tax status of such payments based on the facts below and assuming the umbrella bonus pool has the same attributes as the bonus pool discussed above.

  — **Determination of award amount:** The Compensation Committee determines that target performance goals were achieved, entitling each covered employee to a target payout. The Compensation Committee increases the target payout for each employee based on individual modifiers which solely take into account the achievement of subjective performance goals. The amount of the increase is determined at the sole discretion of the Compensation Committee.

Executive	Earned Target Payout Amount	Percent Increase Based on Individual Modifier	Approved Payout Amount	Covered Employee's Allocable Share of Bonus Pool	Maximum Individual Payout Permitted Under Bonus Plan[1]	Bonus Pool
A	$1,000,000	50%	$1,500,000	$3,200,000	$5,000,000	

Executive	Earned Target Payout Amount	Percent Increase Based on Individual Modifier	Approved Payout Amount	Covered Employee's Allocable Share of Bonus Pool	Maximum Individual Payout Permitted Under Bonus Plan[1]	Bonus Pool
B	$480,000	30%	$624,000	$1,600,000	$5,000,000	
C	$350,000	20%	$420,000	$800,000	$5,000,000	
D	$350,000	20%	$420,000	$800,000	$5,000,000	
E	$350,000	20%	$420,000	$800,000	$5,000,000	
F	$350,000	20%	$420,000	$800,000	$5,000,000	
Total			**$3,804,000**			**$8,000,000**

[1] Pursuant to the requirements of Section 162(m), represents the amount, set higher than any potential maximum bonus opportunity, included in the shareholder approved bonus plan document.

— **Award amounts constitute performance-based compensation:** Despite the use of subjective performance goals and the exercise of discretion to increase award amounts under the underlying operating plan, each of the foregoing award amounts would constitute qualified performance-based compensation. For purposes of Section 162(m), each award amount is considered paid under the umbrella bonus plan, not the underlying incentive plan. The award payments would be considered performance-based compensation because all the requirements relating to an umbrella bonus pool arrangement were satisfied, including:

— No bonus payment exceeded the maximum bonus award approved by shareholders.

— In the aggregate, the covered employees' allocable share of the bonus pool did not exceed 100%.

— The aggregate bonus payments to covered employees did not exceed the bonus pool.

— The exercise of negative discretion (within the umbrella plan), with respect to one covered employee, did not result in an increase in the amount payable to another covered employee.

Since all the requirements under Section 162(m) were satisfied, each covered employee's award payment constitutes performance-based compensation and, therefore, would not be subject to the $1 million deduction limitation.

In conclusion, with annual bonus plans, companies do not need to trade off flexibility in determining appropriate bonus payouts for top executives, with corporate tax-deductibility. The "Umbrella Bonus Pool" concept allows for both flexibility and tax deductibility. However, care must be exercised to ensure all requirements have been fulfilled to achieve this desirable result.

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