

Clients & Friends Memo

Final Regulations on Section 162(m) Deduction Limit Exceptions

April 28, 2015

New final regulations¹ (the “**Final Regulations**”) have been issued clarifying and altering the “qualified performance-based compensation” exception and the transitional “reliance period” exception for newly public companies to the \$1 million limit on deductible compensation for covered employees of public companies.

Overview

Section 162(m) generally limits deductions by publicly held corporations for remuneration paid to “covered employees” in excess of \$1 million per year.²

1. Public corporations nevertheless can deduct the whole amount of compensation paid to “covered employees” if the compensation is “qualified performance-based compensation.” The Final Regulations provide that equity awards must be issued under a shareholder-approved plan that contains a per-employee maximum share limitation in order to qualify for the performance-based compensation exception under section 162(m).³
 - A plan will satisfy the maximum share limitation requirement if it states the maximum number of shares with respect to which stock options, stock appreciation rights, restricted stock, restricted stock units and “other equity-based awards” that may be granted to any individual employee during a specified period under a plan approved by shareholders.
2. If a non-public corporation becomes public (for example, in an IPO or spin-off), then compensation paid pursuant to a compensation plan that existed at the time that the company was not public is not subject to the section 162(m) deduction limitation during a defined “reliance period.”⁴

¹ See 80 Fed. Reg. 16970 (Mar. 31, 2015), available at <http://www.gpo.gov/fdsys/pkg/FR-2015-03-31/pdf/2015-07386.pdf>.

² A public company’s chief executive officer and its three other most highly compensated executive officers (other than its chief financial officer) are “covered employees.” See I.R.C. § 162(m). All references herein are to the Internal Revenue Code, or Treasury regulations promulgated thereunder, unless otherwise noted.

³ The Final Regulations also require that the per-employee share limitation be disclosed to shareholders.

⁴ See Treas. Reg. § 1.162-27(f). This reliance period ends on the earliest of the (i) expiration of the plan, (ii) material modification of the plan, (iii) issuance of all employer stock and other compensation allocated under the plan or (iv) first shareholder meeting at which directors are to be elected that occurs after the close of the third calendar year after the calendar year in which the IPO occurs or, if there was no IPO, the first calendar year after the calendar year in which the corporation became publicly held. In the case of an IPO, the transitional exception applies only to a plan described in the corporation’s IPO prospectus in compliance with all applicable securities laws then in effect.

The Final Regulations provide that compensation paid under restricted stock unit (“RSU”) and phantom stock awards is eligible for this transitional reliance period only if the compensation is actually paid (and the award of RSUs or phantom stock not merely granted) prior to the end of the transitional reliance period. This rule applies to awards of RSUs and phantom stock granted on or after April 1, 2015.

Observations and Takeaways

The Final Regulations place extra focus on equity compensation plan issues that have been the subject of recent shareholder litigation. It is likely that the terms of any public company’s equity incentive plan will receive significant scrutiny, and companies and their counsel should carefully review and develop the terms of their plans with this in mind.

The final regulations became effective on April 1, 2015. Public companies should confirm that their equity plans contain a per-employee maximum share limitation that complies with the Final Regulations. In addition, corporations that have recently become, or may become, public should carefully examine their equity plans, especially if they are using (or intend to use) the section 162(m) transitional reliance period. These companies should consider whether they wish to employ forms of equity compensation other than RSUs and phantom stock, which now clearly qualify for the transitional reliance period only if the compensation for such awards is paid prior to the end of such reliance period.

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If you have any questions about these developments, please contact the individuals listed below or any other member of the [Cadwalader Tax Practice Group](#):

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