

Clients & Friends Memo

IRS Issues Proposed Regulations to Clarify Application of Section 162(m)

July 19, 2011

New proposed regulations¹ clarifying perceived ambiguities in the application of the \$1 million limit on deductible compensation for covered employees,² including the transition rule applicable to privately held corporations that become publicly held, were recently published by the Internal Revenue Service. Companies should review their incentive compensation arrangements to determine whether these proposed regulations, once finalized, will affect such arrangements, and, if so, how such arrangements may need to be modified in order to comply with Section 162(m).

Equity-Based Grants by Newly Public Companies

Section 162(m) generally limits deductions by publicly held corporations for remuneration paid to covered employees in excess of \$1 million per year. However, for privately held corporations that become publicly held, the \$1 million deduction limitation does not apply to any remuneration that is paid pursuant to a compensation plan or agreement that was in place before the corporation became publicly held. This exception applies during a transition period which ends on the earliest of (i) the expiration of the plan or agreement, (ii) the material modification of the plan or agreement, (iii) the issuance of all employer stock and other compensation allocated under the plan or agreement or (iv) the 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.³

¹ See 76 Fed. Reg. 37034 (June 24, 2011), available at <http://www.gpo.gov/fdsys/pkg/FR-2011-06-24/pdf/2011-15653.pdf>.

² See I.R.C. § 162(m) ("Section 162(m)"). All references herein are to the Internal Revenue Code, or Treasury regulations promulgated thereunder, unless otherwise noted.

³ 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. See Treas. Reg. § 1.162-27(f).

The transitional exception applies to any compensation paid under a plan or agreement, including stock-based compensation received by the exercise of a stock option or stock appreciation right, or the substantial vesting of restricted property granted under a plan or agreement if the grant occurred before the end of the transition period.

The IRS notes in the preamble to the proposed regulations that it has received questions as to whether the transitional exception as applied to certain stock-based compensation also covers restricted stock units (“RSUs”) granted, but not paid, prior to the end of the specified transition period. Although the plain language of the regulations does not include RSUs in the list of stock-based compensation covered by the transitional exception, the Treasury Department has previously held that the post-transition period delivery of shares with respect to RSUs granted in reliance on the transitional exception is not subject to the disallowance rule under Section 162(m).⁴ The proposed regulations make it clear that only compensation attributable to stock options, stock appreciation rights and restricted property is covered by the transitional exception, and that all other equity-based awards are within the general Section 162(m) disallowance rule. In other words, while RSUs and phantom stock may be granted in reliance on the transitional exception for private companies that become publicly held, compensation with respect to such grants must also be paid prior to the expiration of the applicable transition period in order to not be subject to the \$1 million deduction limitation of Section 162(m).

Share Limitations for Stock Options and SARs

Section 162(m) generally excludes “qualified performance-based compensation” from its \$1 million deduction limitation.⁵ Generally, qualified performance-based compensation must be paid pursuant to (a) an objective performance goal, (b) established not later than 90 days after the commencement of the period of service to which the performance goal relates by a compensation committee comprising two or more outside directors, (c) the material terms of which were approved by shareholders before the compensation is paid and (d) with the written certification of the compensation committee that all applicable performance goals were met before any amounts are paid out. Compensation attributable to a stock option or a stock appreciation right is deemed to satisfy the requirements for qualified performance-based compensation if (a) the grant or award is made by the compensation committee of outside directors; (b) the plan under which the option or right is granted states the maximum number of shares with respect to which options or rights may be granted during a specified period to any employee; and, (c) under the terms of the option or

⁴ See PLR 200406026 and PLR 200449012.

⁵ Treas. Reg. §§ 1.162-27(e)(2) through (5). Performance-based compensation that meets the requirements specified in the regulations is “qualified performance-based compensation”.

right, the amount of compensation the employee could receive is based solely on an increase in the value of the stock after the date of the grant or award.⁶

Some practitioners have questioned the application of the requirement that a plan state the maximum number of shares with respect to which options or stock appreciation rights may be granted in a specified period to any employee. The proposed regulations make it clear that a “qualified performance-based plan” must state the maximum number of options or stock appreciation rights *per individual employee* that may be granted during a specified period.

Effective Date and Other Considerations

These regulations will apply to the taxable year ending on or after the date the Treasury’s decision to adopt final regulations is published in the Federal Register. Comments to the proposed regulations must be received by September 22, 2011. Any corporation that has recently undergone an IPO should review its stock-based compensation plans and restricted stock unit and phantom stock awards to determine what impact, if any, the proposed regulations will have on such plans and awards once finalized, and publicly-held corporations should review their equity incentive plans for compliance with the Section 162(m) share limitation as clarified by the proposed regulations. In particular, companies that have recently granted RSUs or phantom stock in reliance on the Section 162(m) transitional exception for newly public companies should consider how such awards might need to be modified to comply with the proposed regulations in the event such regulations are finalized in their current form.

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⁶ Treas. Reg. § 1.162-27(e)(2)(vi).