

Executive Compensation Alert: IRS Releases Final Section 162(m) Regulations

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Background

Section 162(m) of the Internal Revenue Code (the “Code”) denies a tax deduction to a public company if the compensation paid to its chief executive officer and three other highest compensated officers (other than the chief financial officer) for a given year exceeds one million dollars for its taxable year. However, there are exceptions to this limitation on deductibility (i) for compensation that is “performance-based” within the meaning of Section 162(m) of the Code and (ii) for compensation that is not “performance-based” within the meaning of Section 162(m) of the Code, but is payable during a transition period, as described in greater detail below, by a newly public company under a plan or agreement that was in existence prior to such company becoming public (the “*IPO Transition Rule*”).

Final Regulations

The Final Regulations adopted on March 31, 2015 clarify that (i) the per-employee limits on equity awards are required in public company plans in order to qualify for the “performance based” exception under Section 162(m) of the Code and (ii) restricted stock units (“RSUs”) will only satisfy the IPO Transition Rule if they are settled or paid during the Transition Period (as defined below); provided, that under transitional relief offered by the Final Regulations, RSUs granted prior to April 1, 2015 and prior to the end of the Transition Period may be settled or paid at any time (including following the end of the Transition Period) and still satisfy the IPO Transition Rule.

Clarification of the Performance-Based Compensation Exception—Maximum Share Limitation

While we do not believe this was ever in doubt, the Final Regulations clarified that the “performance-based” compensation exception will only apply for equity awards that are issued pursuant to a shareholder approved plan that specifies a per-employee limit on the number of options and stock appreciation rights that can be granted during a specified time period (e.g., a calendar year). The Final Regulations clarify that the per-employee limit will be satisfied if the plan specifies an aggregate per-employee limit on the number of shares underlying all equity-based awards that may be granted during the specified period.

Note that an overall aggregate plan limit on the number of shares that may be granted to all participants under the plan will not by itself satisfy this per-employee limit requirement. The Final Regulations provide that the per-employee limit applies to compensation attributable to options and stock appreciation rights granted on or after June 24, 2011.

Clarification of the IPO Transition Rule

Under the IPO Transition Rule, compensation paid by newly-public companies under plans or agreements in effect prior to the company’s IPO (for which adequate disclosure is provided in the IPO prospectus), will not be subject to the \$1M deductibility limit under Section 162(m) of the Code. The IPO Transition Rule is only available during an IPO transition period (the “*Transition Period*”), which lasts until the earliest of (i) the expiration or material modification of the plan or agreement, (ii) the issuance of all stock and other compensation allocated under the plan or agreement, or (iii) the first annual shareholders meeting at which directors are to be elected that occurs after the third calendar year following the year of the IPO. The IPO Transition Rule also requires that the material terms of the prior plans and agreements under which the compensation is granted be disclosed in the IPO Prospectus.

The IPO Transition Rule applies to (i) any cash compensation paid during the Transition Period and (ii) any compensation received pursuant to the exercise of any stock option or stock appreciation right or the vesting of any shares of restricted stock if such compensation was awarded under a plan or agreement satisfying the IPO Transition Rule and if the *grant* of any such stock options, stock appreciation rights or shares of restricted stock was made before the end of the Transition Period (even if such awards vested or were exercised after the end of the Transition Period). Under the Final Regulations, RSUs will be treated less favorably than stock options, stock appreciation rights and shares of restricted stock because the IPO Transition Rule only applies to RSUs that are *settled or paid* during the Transition Period (i.e., if an RSU is granted during the Transition Period, but is not settled until after the end of the Transition Period, it may fail to be deductible under Section 162(m) of the Code, whereas options, stock appreciation rights and shares of restricted stock granted under a prior plan will be deductible

if they are granted during the Transition Period, regardless of when they vest or are exercised).

Importantly, the Final Regulations provide limited relief for RSUs granted during a public company's Transition Period and prior to the April 1, 2015 (*i.e.*, prior to the adoption of the Final Regulations). If RSUs were granted during such period, they will be fully deductible, regardless of when they are paid and settled. Any RSUs granted on or after April 1, 2015 will need to be settled or paid during the company's Transition Period to satisfy the IPO Transition Rule and remain excludable from the limit on deductibility under Section 162(m) of the Code.

What Public Companies Should Do

- Public companies should review their equity plans to confirm that such plans satisfy the per-employee share limitation required by the Final Regulations;
- Newly public companies that are still in their Transition Period (or companies that are contemplating going public) should consider the deductibility of the different forms of equity awards (*i.e.*, restricted stock, RSUs) when determining what type of awards to grant, particularly if awards will have a vesting schedule that will extend beyond the end of the Transition Period;
- Newly public companies in their Transition Period should be aware that RSUs granted during the Transition Period and prior to April 1, 2015 will remain deductible under Section 162(m) of the Code and RSUs granted during the Transition Period and on or after April 1, 2015 will count against the \$1M limit under Section 162(m) of the Code if such RSUs are settled after the end of the Transition Period (and are not otherwise "performance-based" compensation under Section 162(m) of the Code); and
- Companies that are contemplating going public should ensure that the material terms of prior plans and agreements are disclosed in the IPO Prospectus so they can receive the benefits of the IPO Transition Rule.

For more information, you may contact [Laura McIntyre](mailto:Laura.McIntyre@fenwick.com) (650.335.7243–[lmcintyre@fenwick.com](mailto:Laura.McIntyre@fenwick.com)) or any other attorney in the Executive Compensation and Employee Benefits Group at Fenwick & West LLP.

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