

## Executive Compensation Alert:

IRS Issues Proposed Regulations Under Section 162(m) to Clarify Performance-Based Exception

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### BACKGROUND

Section 162(m) of the Internal Revenue Code, denies a tax deduction to a public company if compensation paid to certain individuals (known as “covered employees”) exceeds one million dollars for the taxable year. A “covered employee” is defined as a public company’s chief executive officer and its three other most highly compensated officers (excluding the CFO) whose compensation is required by the SEC to be disclosed for a given year. However, the deduction limit is subject to certain exemptions, including compensation that is “performance-based” within the meaning of Section 162(m), and certain equity awards granted under an equity incentive plan that existed prior to a company becoming public.

### PROPOSED REGULATIONS

On June 23, 2011 the Internal Revenue Service (“IRS”) issued proposed regulations to clarify the existing regulations of Section 162(m) with respect to stock-based compensation plans and the exception to the \$1 million limit for qualified performance-based compensation.

#### *Maximum Number of Shares*

The proposed regulations clarify that an equity incentive plan **must** specify a per person limit for each individual employee on the number of shares that may be granted during a specified period. An equity incentive plan which merely states the maximum number of shares in the aggregate that may be granted under such plan fails to meet the requirements of the exemption for qualified performance-based compensation. An option or stock appreciation right granted with such a per person limit automatically satisfies the performance-based compensation requirement. However, equity

awards other than options or stock appreciation rights, that do not contain performance criteria approved by stockholders in accordance with the regulations will not satisfy the performance-based compensation requirements even with a per person limit.

#### *Required Disclosure*

The proposed regulations also clarify that the shareholder-approval requirement in the current regulations will be satisfied if the maximum number of shares that may be granted to each employee and the exercise price of those options and/or stock appreciation rights are disclosed to shareholders.

#### *Transition Period for Newly Public Companies*

The \$1 million annual deduction limit under Section 162(m) applies to publicly held companies. However, for companies that become public, the proposed regulations clarify that the exemption from Section 162(m) for compensatory arrangements that existed during the time the company was privately held has a limited transition period. Thus, public companies that maintained the incentive plan prior to becoming public may continue to deduct compensation on awards made during the “transition period”, which would end on the earliest of:

1. The expiration of the plan;
2. A material modification of the plan;
3. The issuance of all employer stock and other compensation allocated under the plan; or
4. The first shareholder meeting to elect directors that occurs after the third calendar year following the year of the initial public offering (or first calendar year the company became public, if no initial public offering).

Prior regulations and rulings permitted deductions regardless of when equity awards made during the above “transition period” were exercised (in the case of options or stock appreciation rights) or otherwise taxable. However, the proposed regulations now clarify that the exemption is available only to stock options, stock appreciation rights and restricted stock awarded during the transition period, if exercised or taxable following the end of the transition period. Any grant of restricted stock units or phantom stock made during such “transition period” must be taxable prior to the end of the transition period in order to remain deductible under the exemption.

The proposed regulations are directly contrary to two private letter rulings from the IRS (PLR 200406026 and PLR 200449012), in which the IRS ruled that compensation paid pursuant to restricted stock units after the end of the transition period would not be subject to the \$1 million annual deduction limit under Section 162(m). The proposed regulations are silent as to whether they would apply to existing outstanding awards or only awards granted after the regulations are finalized. However, because the IRS has deemed the proposed regulations as “clarifications” we believe that the final regulations would apply to all outstanding awards as of the date the regulations become final.

## **NEXT STEPS**

The IRS has requested comments no later than September 22, 2011. Once final, the regulations would apply to taxable years on or after the date the final regulations are published in the Federal Register. Public companies, and those that may soon become public, should review their existing incentive plans to ensure that the terms contain limits for both the maximum number of available shares in the aggregate and a separate limit on grants to individuals.

## **For more information, you may contact any attorney in the Executive Compensation and Employee Benefits Group.**

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