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IRS Issues Proposed 162 (m) Regulations Clarifying Rules on Deductibility of Performance-Based Compensation

The Internal Revenue Service has issued proposed regulations under Section 162(m) of the Internal Revenue Code clarifying the ability of public companies to take a tax deduction for equity compensation.

Background

Section 162(m) generally disallows a tax deduction for annual compensation in excess of \$1 million paid to a "covered employee" of a public company (the CEO and the next three highest paid executive officers other than the CFO). Performance-based compensation, however, is exempt from this restriction. Compensation from a stock option or stock appreciation right (SAR) qualifies as performance-based compensation if:

- the grant is made by a compensation committee consisting of at least two independent directors;
- the plan under which the grant is made sets forth the maximum number of shares with respect to which options/SARs may be granted during a specified period to any employee; and
- under the terms of the option or right, the amount of compensation the employee may receive is based solely on an increase in the value of the stock after grant.

Per-Employee Limit Required

The proposed regulations clarify that, in order for options/SARs to qualify as performance-based compensation, the plan must specify "the maximum number of shares with respect to which options or rights may be granted during a specified period to any individual employee." A restriction on the aggregate maximum number of shares that may be awarded to all participants is insufficient. The proposed regulations also clarify that the documentation submitted to shareholders for approval of the plan must disclose this individual limit and the method for determining the exercise price (*e.g.*, fair market value on date of grant).

Newly Public Companies

Under current regulations, in the case of newly public companies, the \$1 million deduction limit does not apply during a transition "reliance period" after the company becomes public. The reliance period ends at the earliest of:

- the expiration of the plan or agreement;
- a material modification of the plan or agreement;
- the issuance of all employer stock and other compensation allocated under the plan or agreement; and

- the first meeting of shareholders after the close of the third calendar year following the IPO (or the close of the first calendar year following the year in which the company became public other than through an IPO).

The current regulations provide that the transition relief described above applies to compensation received on the exercise of stock options/SARs or the vesting of restricted stock as long as the grant occurred before the expiration of the reliance period. Some practitioners believed that this grant-date rule also extended to restricted stock units and phantom stock on the basis that these are the economic equivalent of restricted stock. The proposed regulations clarify that this grant-date rule is available only for stock options/SARs and restricted stock and not for restricted stock units and phantom stock. Therefore, compensation from restricted stock units and phantom stock must be paid, and not merely granted, before the end of the reliance period in order to be covered by the transition relief and exempt from the \$1 million deduction limitation.

Conclusion

While the proposed regulations are subject to comment and may be modified before becoming final, companies should review their equity plans to determine whether any amendments are necessary to comply with the proposed regulations.

Comments may be submitted to the IRS in writing or electronically by September 22, 2011.

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