

IRS Releases Final Regulations Under Section 162(m): Some Relief for Newly Public Companies

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On March 31, 2015, the Internal Revenue Service published [final regulations](#) under Section 162(m) of the Internal Revenue Code. As it did when it [proposed](#) these regulations in 2011, the IRS has indicated that these regulations are not intended to reflect substantive changes to existing requirements of Section 162(m), but rather to clarify them.

The final regulations clarify two requirements for exceptions from the Section 162(m) tax deductibility limit:

- the need for per-employee limits on equity awards in order to qualify stock options and stock appreciation rights (SARs) for the “qualified performance-based compensation” exception; and
- the treatment of restricted stock units (RSUs) or phantom stock arrangements under the transition period exception for certain compensation “paid” by newly public companies.

Importantly, consistent with the proposed regulations, the final regulations clarify that RSUs or phantom stock arrangements granted by newly public companies would not qualify for the transition period exception unless they are settled or paid before the end of the transition period. That said, the final regulations provide some relief by making this clarification only apply to equity-based awards granted on or after April 1, 2015. This means that RSUs and phantom stock arrangements that were granted before April 1, 2015 and during a company’s transition period will remain eligible for tax deductibility, even if they are settled or paid after the end of the transition period.

Background and Final Regulations

Section 162(m) generally limits a publicly held corporation’s federal income tax deduction for compensation paid to any “covered employee” to \$1 million in any taxable year. The “covered employees” are a company’s chief executive officer and its three other most highly compensated executive officers (other than the chief financial officer).

Qualified Performance-Based Compensation. Section 162(m) provides an exception to the \$1 million tax deductibility limitation for “qualified performance-based compensation” (the “**QPBC Exception**”). To qualify for the QPBC Exception, compensation must meet certain requirements. Stock options and SARs granted at fair market value are eligible for the QPBC Exception (without the need for being subject to separate performance goals) if, among other things, the equity compensation plan under which they are granted includes a per-employee limit on the number of options or rights that could be granted in a specified period (e.g., a calendar year), which limit must be disclosed to and approved by the company’s shareholders.

- The final regulations confirm that, in order to qualify for the QPBC Exception, plans under which stock options or SARs may be granted must state the maximum number of shares with respect to which options or rights may be granted during a specified period *to any individual employee* and the price at which they will be granted. This means that the overall plan limit on the aggregate number of shares that may be granted to all recipients over the life of the plan is not sufficient.
- The final regulations further clarify that plans may satisfy this requirement by specifying an aggregate maximum number of shares underlying all equity-based awards (not just stock options or SARs) that may be granted during a specified period to any individual employee.

- The final regulations provide that the per-employee maximum share limitation applies to compensation recognized on the exercise of stock options and SARs granted on or after June 24, 2011, the date of publication of the proposed regulations.

Newly Public Companies. Section 162(m) also provides an exception for newly public companies (the “**IPO Exception**”), giving these companies a chance to transition their compensation structures to comply with the rules under Section 162(m). Under the IPO Exception, the \$1 million tax deductibility limitation does not apply for a transition period to any compensation “paid” pursuant to a plan or agreement that existed during the period in which a company was not publicly held, so long as the disclosure of the plan or agreement satisfied all applicable securities laws. The transition period will last until the earliest of:

- the expiration or material modification of the plan or agreement;
- the issuance of all stock or other compensation allocated under the plan or agreement; and
- generally, the first annual shareholders meeting at which directors are to be elected that occurs after the close of the third calendar year following the calendar year in which the IPO occurs (*e.g.*, for a company that completes its IPO in 2015, the transition period under this prong would end in 2019).¹

The existing regulations provide that the IPO Exception is available for compensation paid, or stock options, SARs or restricted property granted, during the transition period. This means that compensation recognized on the exercise of a stock option or SAR, or the vesting of restricted stock, even if recognized after the end of the transition period, would continue to qualify for the IPO Exception so long as the equity award was granted during the transition period. On the other hand, cash bonuses would not be eligible if they were paid after the transition period.

There has been a question about whether RSUs and phantom stock arrangements should be treated like other equity compensation (in particular, restricted stock) and thus eligible for tax deductibility as long as they are granted during the transition period.

- The final regulations clarify that RSUs or phantom stock arrangements would only qualify for the IPO Exception if they are settled or paid before the end of the transition period.
 - This is consistent with the position taken by the IRS in the proposed regulations and rejects commentators’ request to treat RSUs and phantom stock arrangements in the same way as stock options, SARs and restricted stock under the IPO Exception.
 - Commentators argued that RSUs provide for the same economics as restricted stock and therefore should be treated the same, and pointed out that this was a position accepted by the IRS in prior private letter rulings. However, the IRS rejected this view, noting that RSUs are subject to a different tax regime (Section 409A) from restricted stock (which is governed by Section 83) and that RSUs, unlike restricted stock, are not considered property from a tax perspective.
- Importantly, the final regulations provide some relief for companies that recently became public by making this clarification concerning RSUs and phantom stock arrangements only apply to equity-based awards granted on or after April 1, 2015. This means that RSUs and phantom stock arrangements that were granted before April 1, 2015 and during a company’s transition period will

¹ If the company becomes public without an IPO (*e.g.*, via a spin-off), the transition period under this prong ends upon the first annual shareholders meeting at which directors are to be elected that occurs after the close of the first calendar year following the calendar year in which the company becomes publicly held (*e.g.*, for a company that completes its spin-off in 2015, the transition period under this prong would end in 2017).

remain eligible for tax deductibility under the IPO Exception, even if they are settled or paid after the end of the transition period.

- Stock options, SARs and restricted stock will continue to qualify for the IPO Exception, even if they vest (and, in the case of stock options and SARs, are exercised) after the end of the transition period, so long as they are granted during the transition period.

Practice Notes

In light of these final regulations under Section 162(m):

- Public companies that rely on the QPBC Exception for stock options and SARs should review their equity plan documents to ensure that they satisfy the requisite per-employee maximum share limitation. In our experience, most companies' plans have been drafted to satisfy this requirement.
- Public companies that granted RSUs and phantom stock arrangements during the applicable transition period (but prior to April 1, 2015), and which settle after the transition period, can claim a tax deduction with respect to those awards, assuming that the other applicable requirements of Section 162(m) have been satisfied.
- For newly public companies that are still in their transition period or companies that are contemplating going public, and are considering granting full-value equity awards, restricted stock may be more appealing than RSUs, at least from the perspective of maximizing tax deductibility. This may be particularly true for companies that anticipate having short transition periods or granting awards with long vesting schedules. On the other hand, there may be reasons that such companies nevertheless would favor RSUs (e.g., if they intend to grant performance-based awards that pay out at more than 100% of the face value of the awards if target performance is exceeded).

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