

IRS Clarifies 162(m) Deduction Requirement

by Susan P. Serota and John J. Battaglia

The Internal Revenue Service issued new proposed regulations on June 23 relating to the deduction for employee compensation in excess of \$1,000,000. The proposed regulations clarify (i) the requirement to set forth in the plan document the maximum number of shares to which options and stock appreciation rights may be granted to each individual covered employee and (ii) the application of the transition rule to stock-based compensation for privately held corporations that become publicly held.

Maximum Grants to Individual Employees

In general, unless it meets certain performance-based criteria, compensation paid to a covered employee is not deductible by a publicly held employer if the amount exceeds \$1,000,000 for a taxable year. The \$1,000,000 deduction limitation does not apply to compensation that qualifies as “performance-based compensation” under Code section 162(m) and the applicable Department of Treasury regulations. The current regulations include the following three requirements to determine whether and when the grant of stock options and stock appreciation rights (SARs) constitute performance-based compensation for purposes of this exception:

- i. the grant or award must be made by the compensation committee (consisting of at least two independent directors);
- ii. the plan under which the option or right is granted must state the maximum number of shares with respect to which options or rights may be granted during a specified period to any employee; and
- iii. under the terms of the option or right, the amount of compensation the employee can receive is based solely on an increase in the value of the stock after the date of the grant or award.

With respect to condition (ii) above, a transition rule had applied to plans receiving shareholder approval prior to December 20, 1993, which permitted the plan to state only the aggregate number of shares available. This transition period was available at most until the end of 1996. Thus, current grants under a plan that was approved by shareholders but does not state the individual maximum grants will not be deemed to be performance-based. The new proposed regulation would clarify that not only must the plan state the

aggregate number of shares that may be granted under the plan to all employees, but also the maximum number of shares that may be granted to each individual employee during a specified period. The proposed regulation further clarifies that a plan can satisfy this condition by stating an aggregate maximum share number and providing that each individual employee may be granted options or SARs to receive the maximum number of shares authorized under the plan during a specified period.

Transition Rule for Companies That Become Public

Under the current regulations, in the case of a non-public corporation that becomes a publicly held corporation, the \$1,000,000 deduction limitation does not apply to compensation paid under a plan or agreement that was in effect when the corporation was not publicly held. In the case of an initial public offering, this relief is available only to the extent that the IPO prospectus provided appropriate disclosure of the compensation plans in a manner that satisfied all applicable security laws. Further, this relief is available only during the “reliance period,” which ends at the earliest of (i) the expiration of the plan or agreement, (ii) a material modification of the plan or agreement, (iii) the issuance of all employer stock and other compensation allocated under the plan or agreement and (iv) the first meeting of shareholders at which directors are elected that occurs after the third year following the year of the IPO (or if no IPO, after the first year following the year the corporation became public).

In the case of stock-based compensation, a special rule in the current regulations provides that the transition relief applies to compensation received pursuant to the exercise of stock options or SARs or the substantial vesting of restricted property if the grant occurred before the end of the applicable reliance period described above. The new proposed regulation clarifies that this relief is available only for stock options, SARs and restricted property and not for other equity-based awards such as restricted stock units or phantom stock arrangements. Thus compensation attributable to these other types of equity-based awards must be paid, not merely granted, on or before the end of the reliance period for the deduction limitation not to apply.

Public companies should review their 162(m) plan documents to determine whether any amendments are needed to conform to the new proposed regulations.

If you have any questions about the content of this publication, please contact the Pillsbury attorney with whom you regularly work or the Executive Compensation & Benefits group.

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