

Client Update

IRS Confirms Restricted Use of 162(m) IPO Transition Rule

NEW YORK

Elizabeth Pagel Serebransky
epagel@debevoise.com

Jonathan F. Lewis
jflewis@debevoise.com

Charles E. Wachsstock
cewachsstock
@debevoise.com

Meir D. Katz
mdkatz@debevoise.com

Oleg S. Zakatov
oszakatov@debevoise.com

The Internal Revenue Service (“IRS”) has adopted final rules amending its regulations under Section 162(m) of the Internal Revenue Code (“Section 162(m)”) to clarify how certain exemptions apply to equity-based compensation.

Section 162(m) limits deductions for compensation paid to the Chief Executive Officer and the three most highly compensated officers (other than the CEO and CFO) by any publicly held corporation to the extent that the compensation for the taxable year exceeds \$1,000,000. The deduction limitations do not apply to qualified performance-based compensation or, for newly public companies, compensation paid under plans and agreements that existed prior to the IPO during a post-IPO transition period. The new rules clarify how certain equity-based compensation may qualify for those exemptions.

OPTIONS AND RSUs TREATED DIFFERENTLY UNDER POST-IPO TRANSITION RULES

The Section 162(m) deduction limitations do not apply to remuneration paid by a newly public corporation under a compensation plan or agreement that existed at the time of the public offering, if paid during a post-IPO transition period.

The regulations provide additional transition relief for compensation received as a result of the exercise of stock options or stock appreciation rights, or vesting of restricted property. Compensation under options, stock appreciation rights and restricted stock is exempt so long as the equity, options or restricted stock were granted during the transition period. The new regulations confirm that only options, SARs and restricted stock get this relief. Restricted stock units, performance share units that do not otherwise qualify for the performance-based compensation exemption, and other kinds of equity awards are instead treated like cash compensation. Thus, compensation under RSUs is eligible for transition relief only if it is paid, and not merely granted, during the transition period.

These new stricter post-IPO exempt transition period regulations for RSUs apply to compensation granted on or after March 31, 2015. Thus, corporations may treat RSUs granted prior to March 31, 2015 (regardless of when the RSUs will

vest or settle) in the same manner as options and restricted stock. This is a more relaxed approach than had been indicated in the proposed regulations, and will provide an unexpected tax benefit to companies that have granted RSUs or performance share units during the transition period that will not settle until after the transition period.

PER-EMPLOYEE MAXIMUM SHARE REQUIREMENT

The new rules clarify that compensation payable under options or stock appreciation rights does not qualify for the performance-based compensation exemption under Section 162(m) unless the plan under which the grant is made specifies “the maximum number of shares with respect to which options or rights may be granted during a specified period to any individual employee” (the “per-employee limitation”). Aggregate employee or plan limits do not suffice for this purpose. The plan must specify a per-employee share limit for a specified period of time (*i.e.*, a calendar or fiscal year or a specific multi-year period). The per-employee limitation requirement may be satisfied if the plan specifies a per-employee maximum number of shares with respect to which stock options and stock appreciation rights may be granted for the specified period, or, in a change from the proposed regulations, by specifying a per-employee aggregate maximum number of shares with respect to all categories of equity-based awards for the specified period. By way of example, a provision stating that a maximum of 100,000 shares can be awarded as options to all employees during a calendar year with no individual employee limitation would not meet the share maximum requirement. On the other hand, a provision stating that a maximum of 100,000 shares can be awarded as options or SARs to any individual employee during a calendar year would meet the share maximum requirement, as would a provision stating that a maximum of 100,000 shares can be awarded as equity-based compensation to any individual employee during a calendar year.

The per-employee maximum number of shares must be included in the plan and disclosed to the shareholders of the corporation at the time of shareholder approval.

These regulations apply retroactively to stock options and stock appreciation rights granted on or after June 24, 2011, when the IRS initially proposed the clarifying rules.

* * *

Please do not hesitate to contact us with any questions.