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The IRS has issued proposed Treasury Regulations addressing important changes to rules related to performance-based compensation for top executive officers of public companies.

# IRS Proposed Regulations Clarify Certain Equity Compensation Rules Under IRC Section 162(m)

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Section 162(m) of the Internal Revenue Code (the "Code") generally limits the deductibility of compensation paid by a publicly traded corporation to its top executive officers (the "covered employees") to $1 million annually (the "Million Dollar Cap"). However, this limit will not apply to certain amounts that qualify as "performance-based compensation." Compensation attributable to stock options, stock appreciation rights ("SARs") and restricted stock grants may qualify as performance-based compensation if they meet certain requirements. The IRS recently issued proposed Treasury Regulations that "clarify" two aspects of the current Section 162(m) rules relating to equity-based compensation. The areas addressed include: (1) a transition rule for awards made shortly after a company becomes publicly traded; and (2) the required limit on the number of shares subject to grants of stock options or SARs.

## Transition Rules for Newly Public Companies

Current Treasury Regulations promulgated in connection with the Million Dollar Cap provide that certain awards granted under a compensation plan or agreement by a company before it became publicly held will not be subject to the Million Dollar Cap. This relief is available for a transition period that ends when the earliest of the following events occurs: (1) the expiration of the plan or agreement; (2) the material modification of the plan or agreement; (3) the issuance of all employer stock and other compensation allocated under the plan; or (4) the first meeting of shareholders to elect directors that occurs after the end of the third calendar year following the year of the IPO (for a company that becomes publicly held without an IPO, the transitional period ends no later than the first calendar year after the year in which the company becomes publicly held). This means that grants of options, SARs and restricted shares made prior to the end of the transition period would benefit from the exemption from the Million Dollar Cap, even if the taxable compensation (and corresponding deduction by the company) occurs after the end of the transition period.

Because of different interpretations of this rule in regulatory guidance, it was unclear if the exemption from the Million Dollar Cap was also available for grants of stock options, SARs and restricted stock extended to the grants of restricted stock units ("RSUs") or phantom stock. The proposed regulations resolve this issue by specifying

that "compensation payable under a restricted stock unit arrangement or a phantom stock arrangement must be **paid, rather than merely granted**, on or before" the date that the transition period ends. Although presented merely as a clarification, the proposed rule directly contradicts at least two IRS private letter rulings that held that RSUs granted during the transition period were exempt from the Million Dollar Cap even if they were paid after the transition period. While not discussed by the IRS, it is possible that some relief may be available for grants made prior to the publication of these proposed changes to the regulations.

In accord with the proposed rule, companies going public should consider paying out RSUs or phantom stock before the end of the transition period in order for such compensation to be exempt from the Million Dollar Cap. The text of the proposed regulations provide that this clarification is effective when final regulations are published; however, the preamble to these proposed regulations provides that the rule is effective in taxable years ending on or after the date of publication of the final regulations.

## Limit on Number of Shares Awarded

An exception to the Million Dollar Cap permits an unlimited deduction for amounts that qualify as "performance-based compensation." The current Treasury Regulations require that, in order for the compensation flowing from the exercise of a stock option or SAR to qualify as "performance-based compensation," the shareholder-approved plan under which such grants are made must, among other things, specify the maximum number of shares that may be subject to grants or awards that are issued to any one employee during a specified period.

Apparently, the IRS believed that there was a need to clarify certain aspects of these requirements due to the fact that certain plans may have included limits on the total number of awards made under the plan without specifying individual limits for options and SARs. As a result, the proposed regulations make clear that the plan needs to expressly set forth the maximum amount of shares that may be subject to options or SARs granted to any individual employee during a specified period. While most option and SAR plans of public companies already comply with this requirement, it is still advisable to review existing stock based compensation plans intended to meet the requirements of Code section 162(m) to be sure the plans contain not only an aggregate limit on the number of shares that may be subject to grants under the plan, but also a separate limit that applies to grants of options and SARs to any one employee during a specified period (*e.g.*, during any one fiscal year). Once the rules are finalized, this clarification is effective retroactive to June 24, 2011.

Littler Mendelson attorneys routinely draft compensation plans and agreements to ensure that the adverse effects of section 162(m) are minimized for both employers and employees. Employers may consult their Litter attorney or experienced benefits counsel to review any current agreements to assess what changes may be necessary or appropriate in light of these newly proposed rules.

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