Client Alert

Employment, Compensation and Benefits

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IRS Publishes Final Regulations Under Section 162(m)

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Background

On March 31, 2015, final regulations of Internal Revenue Code Section 162(m) were published. The final regulations clarify exceptions to the US$1 million annual limit on deductions allowable to publicly held corporations for compensation paid to "covered employees." Covered employees include certain executive officers, such as the chief executive officer and the corporation's three other most highly compensated executive officers other than the chief financial officer. Generally, compensation paid by a publicly held corporation to its covered employees in excess of US$1 million per year is not tax deductible. This US$1 million limitation however is subject to certain exceptions, which include exceptions on performance-based compensation and compensation paid pursuant to a plan that existed prior to the corporation becoming public. The Section 162(m) final regulations amend and clarify the existing proposed regulations with regard to these two exceptions. Namely, the final regulations clarify that equity plans must provide individual limits on issuable stock, and that restricted stock units granted by newly public corporations must be paid (and not just granted) prior to the end of the transition period.

Per-Employee Limit on Issuable Shares

The main exception to the US$1 million limit on tax deductions is for performance-based compensation. In order for the exception to apply, according to the proposed regulations, the equity plan pursuant to which the performance-based compensation is paid must specify the maximum number of shares issuable with respect to the stock options and stock appreciation rights ("SARs") awarded to any particular employee in a specified period as well as the grant price. Further, the per-employee limit must be approved by shareholders. The final regulations clarify that this per-employee or per-participant limitation requirement, in addition to stock options and SARS, also applies to other equity awards, including restricted stock and restricted stock units under a plan approved by shareholders. In the case of compensation payments made to eligible participants under equity plans containing only an aggregate limit on the number of issuable shares but not a per-participant limit, the Section 162(m) exception will not apply, unless the plan was approved by shareholders prior to December 20, 1993 and a reliance or transition period specified in the regulations for such plan has not expired. The final regulations further specify that the clarification regarding the per-participant limit applies to compensation paid upon the exercise of stock options and SARs granted on or after the publication date of the proposed regulations, which was June 24, 2011. Prior to this guidance, many companies did not have separate per-participant limitations for awards of restricted stock or restricted stock units and viewed the maximum number of shares under the plan as the only per-participant limitation.

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Newly Public Company

The Newly Public Company exception to the US$1 million deduction limit applies to public corporations that have recently become publicly held. For such corporations, the US$1 million limit on deductibility will not apply to any compensation paid, including compensation from the exercise of stock options or SARS, or the vesting of restricted stock, granted under a plan or agreement that existed before the corporation went public. This exception extends for a transition period that expires the earlier of (a) the expiration of the plan or agreement; (b) material modification of the plan or agreement; (c) the issuance of all employer stock and other compensation allocated under the plan; or (d) the first shareholder's meeting at which directors are elected after the close of the third calendar year following the year in which the initial public offering (an "IPO") occurred (or the close of the first calendar year following the calendar year in which the company became publicly held other than through an IPO). For companies that become publicly held through an IPO, the transition relief applies only to the extent that the plan or agreement was disclosed in the prospectus accompanying the IPO. The exception on deductibility will apply to restricted stock and stock options that have been granted before the transition period expires, even if not vested or exercised prior to the expiration of the transition period. The final regulations also clarify how restricted stock units and phantom stock arrangements should be treated for newly public companies. In particular, the final regulations clarify that such phantom stock awards including restricted stock units, if granted on or after April 1, 2015, will qualify for the exception only if settled or delivered (and not just granted) before the end of the transition period (as noted above). However, the final regulations make it clear that restricted stock units and other phantom stock awards granted during the transition period and before April 1, 2015, will continue to be eligible for tax deductibility, even if they are settled or paid after the transition period ends. Given the clarifications in the final Section 162(m) regulations, newly public companies and companies that are considering going public should consider the vesting and delivery schedule of phantom stock awards, including restricted stock units and in certain circumstances may want to consider granting restricted stock or options to executives who may be subject to the limitations of Section 162(m).