

## *Client Alert*

# IRS Issues Final 162(m) Regulations That Clarify Aspects of Certain Exceptions

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## **EXEQUITY**

Independent Board and  
Management Advisors

On March 31, 2015, the Internal Revenue Service (IRS) published final regulations<sup>1</sup> under Section 162(m) of the Internal Revenue Code. The IRS indicated that the regulations are not intended to embody substantive changes, but rather clarification of certain aspects of the application of Section 162(m). The IRS had issued proposed regulations on June 24, 2011 and these final regulations modify some of what was initially proposed.

The clarifications included in the final regulations primarily focus on two areas:

- The need for equity plan documents to contain per-employee limits on equity awards in order to qualify the grants of such awards for the qualified performance-based compensation exception (QPBC Exception); and
- The treatment of restricted stock units (RSUs) and phantom stock arrangements with regard to the transition period afforded to newly public companies.

### **Section 162(m) Background**

Section 162(m) generally prohibits companies from taking a deduction for compensation in excess of \$1 million (\$0.5 million for certain companies) paid to certain executives (the Chief Executive Officer and the three highest-paid executive officers disclosed in the proxy other than the Chief Financial Officer). However, Section 162(m) provides that certain compensation will not be counted towards such limit. Two common exceptions used by companies are the QPBC Exception and the exception afforded to newly public companies for compensation during a specified transition period.

### **Per-Employee Limits**

The QPBC Exception applies to compensation that meets certain requirements, including being paid based on the achievement of a preestablished goal set by outside directors under a plan or arrangement approved by shareholders, after the directors certify the achievement of such goal(s).

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<sup>1</sup> Certain Employee Remuneration in Excess of \$1,000,000 Under Internal Revenue Code Section 162(m), 26 CFR Part 1, TD 9716, Federal Register, Vol. 80, No. 61, 16970, available at: <http://www.gpo.gov/fdsys/pkg/FR-2015-03-31/pdf/2015-07386.pdf>.

One of the specific requirements with respect to the plan is that it state “the maximum number of shares with respect to which options or rights may be granted during a specified period to any individual employee.”<sup>2</sup> The final regulations clarify that a plan will satisfy this requirement if it specifies an aggregate maximum number of shares with respect to which stock options, stock appreciation rights, restricted stock, RSUs, and other equity-based awards may be granted to any individual employee during a specified period under a plan approved by shareholders in accordance with Treasury Regulation 1.162-27(e)(4).

**Timing:** Because the IRS views this as a clarification in keeping with the legislative history of Section 162(m), it decided that the clarification will apply to compensation attributable to stock options and stock appreciation rights granted on or after June 24, 2011.

**Exequity Commentary:** *All equity compensation plans that are intended to qualify for the QPBC Exception should be reviewed to ensure that they include appropriate per-employee limits for the equity awards grantable under such plans. An aggregate overall share limit on particular awards that is not expressed on a per-employee basis will be insufficient. Failure to have such per-employee award limits could result in awards under the plan failing to qualify for the QPBC Exception and therefore count towards the applicable Section 162(m) compensation limit.*

### RSUs Paid Out by Newly Public Companies

The Section 162(m) deduction limitation does not apply to any compensation paid pursuant to a compensation plan or agreement that existed during the period in which the corporation was not publicly held.<sup>3</sup> A newly public company may rely on this exception until the earliest of:

- The expiration of the plan or agreement;
- A material modification of the plan or agreement;
- The issuance of all employer stock and other compensation that has been allocated under the plan or agreement; or
- The first meeting of shareholders at which directors are to be elected that occurs after the close of the third calendar year following the calendar year in which an initial public offering (IPO) occurs, or, in the case of a privately held corporation that becomes publicly held without an IPO, the first calendar year following the calendar year in which the corporation becomes publicly held (IPO Exception).<sup>4</sup>

This exception for newly public companies applies to any compensation received pursuant to the exercise of a stock option or stock appreciation right, or the substantial vesting of restricted property, granted under a plan or agreement described in Treasury Regulation 1.162-27(f)(1) if the grant occurs on or before the earliest of the events specified above. The proposed regulations identified RSUs and phantom stock arrangements as being ineligible for this transition relief, and the final regulations concurred in that conclusion. As a result, compensation payable pursuant to an RSU or phantom stock arrangement will only be eligible for the transition relief if it is **paid**, and *not merely granted*, before the earliest of the above-specified events.

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<sup>2</sup> Treas. Reg. 1.162-27(e)(2)(vi)(A).

<sup>3</sup> Treas. Reg. 1.162-27(f)(1).

<sup>4</sup> Treas. Reg. 1.162-27(f)(2).

**Timing:** While the IRS views this final regulation as merely clarifying the existing regulations under Section 162(m), it decided that this provision would apply to any compensation that is otherwise deductible resulting from a stock option, stock appreciation right, restricted stock (or other property), RSU, or any other form of equity-based remuneration that is granted on or after April 1, 2015.

**Exequity Commentary:** *Newly public companies that granted RSUs during their applicable transition period but before April 1, 2015 should still be able to claim a deduction for such awards pursuant to the IPO Exception. For newly public companies (other than spin-offs from public companies that become public) that desire to make awards on or after April 1, 2015 during their applicable transition period, consideration should be given to granting restricted stock instead to ensure tax deductibility, or the company should ensure that any RSUs granted will vest and pay out prior to the end of the applicable transition period.*



If you have any questions about this **Client Alert**, please contact Ed Hauder ((847) 996-3990 or [Edward.Hauder@exqty.com](mailto:Edward.Hauder@exqty.com)) or any of the following:

Ben Burney	(847) 996-3970	<a href="mailto:Ben.Burney@exqty.com">Ben.Burney@exqty.com</a>
David Cahn	(847) 996-3965	<a href="mailto:David.Cahn@exqty.com">David.Cahn@exqty.com</a>
Robbi Fox	(847) 948-8655	<a href="mailto:Robbi.Fox@exqty.com">Robbi.Fox@exqty.com</a>
Mark Gordon	(925) 478-8294	<a href="mailto:Mark.Gordon@exqty.com">Mark.Gordon@exqty.com</a>
Jeff Hyman	(203) 210-7046	<a href="mailto:Jeff.Hyman@exqty.com">Jeff.Hyman@exqty.com</a>
Lynn Joy	(847) 996-3963	<a href="mailto:Lynn.Joy@exqty.com">Lynn.Joy@exqty.com</a>
Stacey Joy	(847) 996-3969	<a href="mailto:Stacey.Joy@exqty.com">Stacey.Joy@exqty.com</a>
Chad Mitchell	(949) 748-6169	<a href="mailto:Chad.Mitchell@exqty.com">Chad.Mitchell@exqty.com</a>
Jeff Pullen	(847) 996-3967	<a href="mailto:Jeff.Pullen@exqty.com">Jeff.Pullen@exqty.com</a>
Dianna Purcell	(718) 273-7444	<a href="mailto:Dianna.Purcell@exqty.com">Dianna.Purcell@exqty.com</a>
Bob Reilley	(856) 206-9852	<a href="mailto:Bob.Reilley@exqty.com">Bob.Reilley@exqty.com</a>
Mike Sorensen	(847) 996-3996	<a href="mailto:Mike.Sorensen@exqty.com">Mike.Sorensen@exqty.com</a>
Ross Zimmerman	(847) 996-3999	<a href="mailto:Ross.Zimmerman@exqty.com">Ross.Zimmerman@exqty.com</a>

Illinois Office (Headquarters) – 1870 West Winchester Road, Suite 141 • Libertyville, IL 60048

California Offices – 650 Town Center Drive, Suite 830 • Costa Mesa, CA 92626

– 2840 Comistas Drive • Walnut Creek, CA 94598

Connecticut Office – 108 Pine Ridge Road • Wilton, CT 06897

New Jersey Office – 309 Fellowship Road, Suite 200 • Mt. Laurel, NJ 08054

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