

Proposed Regulations Under Code Section 162(m)

Recently, the Internal Revenue Service issued proposed regulations under Code Section 162(m). The proposed regulations clarify certain requirements with respect to the performance-based compensation exemption from Section 162(m)'s \$1 million deduction limit otherwise applicable to compensation paid to certain public company executives. In addition, the regulations clarify the scope of the transition relief from the general application of Section 162(m) available to a corporation that becomes publicly held. These proposed regulations are intended to clarify the application of the existing Section 162(m) regulations.

Individual Limitation on Maximum Number of Shares

Under the existing regulations, compensation attributable to stock options or stock appreciation rights qualify for the performance-based compensation exemption if: (1) the option or grant is made by the compensation committee; (2) the plan under which the option or right is granted states the maximum number of shares with respect to which options or rights may be granted during a specified period to any employee; and (3) 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 grant date.

The proposed regulations clarify that a plan must state a per-employee limitation on the number of shares that may be granted during a specified period. A plan that includes an aggregate limit on the number of shares that may be granted but does not include an individual limit for each employee fails to meet the second prong of the performance-based compensation requirement described above.

The proposed regulations also clarify the shareholder disclosure and approval requirements applicable to stock options and stock appreciation rights. The description provided to

shareholders must include both the maximum number of shares for which grants may be made to each individual employee during a specified period and the exercise price of the options to satisfy the performance-based compensation exemption.

Scope of Transition Relief for New Public Companies

The existing regulations provide new public companies temporary relief from Section 162(m)'s \$1 million deduction limit for any compensation paid under a plan or agreement that existed before the company became public.

A company may rely on this transition relief until the earliest of: (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 that has been allocated under the plan; or (4) 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 the initial public offering (IPO) occurs or, in the case of a company that becomes public without an IPO, the first calendar year following the calendar year in which the company becomes public.

However, compensation under certain equity incentive plans is not required to be paid during the transition period described above to receive the transition relief. The relief is available to new public companies with respect to compensation attributable to the exercise of a stock option or a stock appreciation right, or the vesting of restricted property, so long as the grant is made under a pre-existing plan during the transition period, even if the compensation is paid after the transition period has expired.

The proposed regulations clarify that this special relief for compensation paid after the transition period only applies to stock options, stock appreciation rights and

restricted property. Equity awards in any other form, such as restricted stock units or phantom stock, must be paid during the transition period in order to qualify for the transition relief.

The proposed regulations will apply to taxable years ending on or after the date of publication of these regulations as final in the Federal Register. Public companies, as well as private companies considering going public, should review their compensation plans and agreements to determine whether any amendments will be necessary to comply with the proposed regulations.

Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at www.dechert.com/employee_benefits.

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