

**IRS PROPOSES NEW REGULATIONS TO CLARIFY SECTION 162(M)
PERFORMANCE-BASED COMPENSATION EXEMPTION**

July 13, 2011

The IRS and Treasury Department have proposed new regulations under Section 162(m) of the Internal Revenue Code of 1986, as amended (“Code Section 162(m)”), relating to two aspects of the deduction limitation for certain executive compensation.¹ The proposed regulations clarify that performance-based compensation attributable to stock options and stock appreciation rights (“SARs”) must specify the maximum number of shares with respect to which such awards may be granted to each individual employee. In addition, the proposals also clarify the scope of a transition rule for newly public companies. Comments on the proposed regulations must be received by September 22, 2011.

Code Section 162(m) Award Limitations for Stock Options and SARs

Code Section 162(m) denies a deduction to publicly held companies with respect to compensation paid to any covered employee to the extent that the amount of the employee’s remuneration for a taxable year exceeds \$1,000,000 unless (among other exceptions) the compensation qualifies as “performance-based compensation.”² If the compensation is considered “performance-based” under Code Section 162(m), it may be deductible by the company even if it exceeds \$1,000,000 for a taxable year.

Stock options and SARs will generally qualify as performance-based compensation if (1) the grant is made by the company’s compensation committee; (2) the plan under which the option or SAR is granted states the maximum number of shares with respect to which options or SARs may be granted during a specified period to any employee; and (3) under the terms of the option or SAR, 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 the award limitation described in (2) above must be a per-employee limitation and not an overall plan limitation on the number of shares that may be granted.³

The proposed regulations still leave unclear the question of whether a per-person award limitation that applies to all types of awards granted under a plan (as opposed to a limitation solely on options and/or SARs) is sufficient. However, we have been informally advised by an IRS representative that a per-person

¹ The proposed regulations, as published in the Federal Register on June 24, 2011, are available at: <http://frwebgate1.access.gpo.gov/cgi-bin/PDFgate.cgi?WAISdocID=P0vgxp/0/2/0&WASAction=retrieve>.

² Covered employees are defined as the principal executive officer and the three other highest compensated officers (other than the principal executive officer or the principal financial officer) as of the end of the taxable year.

³ However, although a general overall plan share limitation (as opposed to participant award limitation) does not suffice, a plan would still be considered performance-based if the plan specified that an individual employee may be granted options or SARs to receive the maximum number of shares authorized under the plan during a specified period.

award limitation on all types of awards granted under the plan would meet the requirements under Code Section 162(m), and we hope that the final regulations will clarify that point.

In addition, Code Section 162(m) also requires that the maximum amount of compensation that may be paid to an individual employee during a specified period be disclosed to, and approved by, the company's shareholders. The proposed regulations clarify this requirement with respect to stock options and SARs by stating that it is sufficient to disclose (1) the maximum number of shares for which options may be granted to any individual employee during a specified period and (2) the exercise price of those options (e.g., fair market value on the date of grant) since shareholders could then calculate the maximum amount of compensation that would be attributable upon exercise of the awards based on their assumptions as to future stock price.

Transition Guidance for Newly Public Companies

For newly public companies, during a transition period, the Code Section 162(m) \$1,000,000 deduction limitation does not apply to compensation paid under plans or agreements that were in effect while the company was private (if the company becomes public through an initial public offering, the plans or agreements must be disclosed in the IPO prospectus). This transition period extends 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 shareholder meeting at which directors are elected that occurs after the close of the third calendar year following the calendar year in which the IPO occurs (or the close of the first calendar year following the calendar year in which a company becomes public if not through an IPO). Compensation received in connection with the exercise of a stock option or SAR or the substantial vesting of restricted stock is exempt provided that such awards were granted during or before the transition period described above, even if the compensation is paid after the end of such transition period.

In response to confusion over the scope of this rule, the proposed regulations explicitly state that the transition rule for compensation paid pursuant to stock options, SARs and restricted stock only applies to those types of awards. Thus, compensation related to other types of awards, including restricted stock units and phantom stock awards, must be paid, rather than merely granted, on or before the end of the transition period. Notably, this proposed guidance would reverse previous IRS private letter rulings addressing the applicability of the transition rule to restricted stock units.

Conclusion

The final regulations are expected to apply to taxable years ending on or after the date of their publication in the Federal Register. Public companies and private companies that are considering going public should review their plans and arrangements to assess whether amendments will be necessary to comply with the final regulations. If you have any questions regarding the proposed regulations, please contact [Meredith Burbank](#), the principal drafter of this client alert, or you may contact one of our Corporate and Securities attorneys at the following link: <http://www.wcsr.com/profSearch?team=corporateandsecurities> or one of our Employee Benefits attorneys at the following link: <http://www.wcsr.com/profSearch?team=employeebenefits>.

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