

## **IRS Issues Proposed Rules On Performance-Based Pay**

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[Ben F. Wells](#)

On June 23, 2011 the Internal Revenue Service issued proposed regulations with regard to the definition of "performance-based compensation" under Section 162(m) of the Code. While these regulations only purport to clarify the existing rules, publicly held employers who take advantage of the performance-based compensation exception should pay careful attention to them.

### **Background.**

Section 162(m) of the Internal Revenue Code limits the deduction available to any publicly-held corporation for any compensation paid to an employee which exceeds \$1 million in a taxable year. However, there is an exception to this limitation for certain types of compensation, including "qualified performance-based compensation." To meet this definition, the compensation must, among other things, be paid solely on account of the attainment of one or more pre-established, objective performance goals. Under the existing regulations, compensation from a stock option or a stock appreciation right (SAR) is deemed to satisfy the performance goal requirement if (i) the grant or award is made by the company's compensation committee; (ii) 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 (iii) under the terms of the option or right, the amount of compensation the employee could receive is based solely on an increase in the value of the stock after the date of the grant or award.

### **Per-Employee Limit on Share Awards**

The IRS and the Treasury Department have reportedly received questions regarding the requirement that a plan must state the maximum number of shares with respect to which options or SARs may be granted to any employee to qualify as performance-based compensation. Some plans only state an aggregate limit on such awards.

The new proposed regulations "clarify" the prior regulations by specifically requiring that a plan specify the maximum number of shares with respect to which options or rights may be granted to any individual employee during a specified period. Thus, if a plan states an aggregate maximum number of shares that may be granted but does not contain a specific per-employee limitation on the number of options or SARs that may be granted, then any compensation attributable to the options or SARs granted under the plan is not qualified performance-based compensation for purposes of Section 162(m).

## **Treatment of Newly Public Companies**

The regulations also contain a further “clarification” with regard to the treatment of newly public companies. As mentioned above, the deduction limit under Section 162(m) only applies to publicly-held corporations. For companies that go through an IPO or otherwise become public, the proposed regulations clarify the available exemption from 162(m) for arrangements that existed during the time that the company was private. Under the existing regulations, an exemption is available for existing plans during a “reliance period.” The reliance period extends until the earliest of (i) the expiration of the plan or agreement; (ii) the material modification of the plan; (iii) the issuance of all employer stock and other compensation allocated under the plan; or (iv) 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 IPO or other going-public event occurs.

The current regulations state that, for stock-based compensation, the reliance period is available for awards granted during the reliance period, even if the income is recognized after the end of the period. The proposed regulations clarify that this rule applies only to grants of restricted stock, options or SARs that occur during the reliance period. With respect to any other compensation or award (such as phantom stock or deferred compensation), the rule only applies to compensation recognized during the reliance period.

## **Necessity for Regulations and Effective Date**

The IRS states that the proposed regulations are “clarifications” since the issues addressed were purportedly dealt with in the preamble to the prior regulations. According to informal statements of Treasury Department officials, it is the intent of IRS and Treasury to move away from the previous practice of including substantive rules or clarifications in the preamble to regulations. Many practitioners do not review preambles and may be less familiar with the preambles to regulations as time passes. Therefore, the Treasury Department viewed it as appropriate to incorporate more specific language into the regulations themselves.

The regulations are proposed to be effective for taxable years ending on or after the date of publication of the final regulations in the Federal Register.

## **Action Required**

Any corporation which is public or which may become public should review its existing performance pay plans to determine whether the required individual limitation is included in the plan. If not, it may be appropriate to amend the plan in anticipation of the issuance of final regulations. Once final regulations are issued, they will, for most purposes, be effective immediately. Therefore, since the IRS views these rules as a clarification of requirements already in effect, there would seem to be little reason to wait until the issuance of final regulations before making changes to a plan.