

Proposed Regulations on 162(m) Deduction Limitation

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Recently, the IRS issued proposed regulations concerning the \$1 million deduction limitation for public company executive compensation, set forth in section 162(m) of the Internal Revenue Code. The proposed regulations clarify two important issues under the current rules, relating to:

- The requirements for compensation attributable to stock options or stock appreciation rights to qualify for an exemption from the deduction limit as "performance-based compensation"
- Application of the transition rule for privately held companies that become public

A brief summary of the proposed regulations is included below. If finalized during 2011, these regulations could apply to the 2011 tax year.

We recommend that public companies review their shareholder-approved equity compensation plan provisions now, to determine whether an amendment would be necessary under the rules as proposed. Additionally, public companies currently operating in a section 162(m) transition period should consider whether to limit equity-based award grants to the types of awards with more favorable transition treatment, as further explained below.

Maximum Grants to an Employee

Generally, section 162(m) disallows a deduction for annual compensation in excess of \$1 million paid to certain "covered employees" (the principal executive officer and the three highest-paid executive officers other than the principal executive officer or the principal financial officer). Stock options or stock appreciation rights may qualify for an exemption from the deduction limit set forth in the current regulations under section 162(m) for "performance-based compensation."

Several requirements must be met for stock options or stock appreciation rights to qualify as "performance based," one of which is that the plan must state the maximum number of shares with respect to which options or rights may be granted during a specified period to any employee.

The proposed regulations clarify that this requirement will only be satisfied when a plan contains a specific per-employee limit on the number of shares that may be granted during a specified period. It is not enough for a plan to provide an aggregate maximum number of shares that may be granted. Further, the documentation submitted for shareholder approval of the plan must disclose this individual limit, as well as the method for determining the exercise price (generally, the fair market value on the date of grant).



Stock-Based Compensation Under the Transition Rule

Under current regulations, for a limited period after a company becomes publicly traded, the \$1 million deduction limitation does not apply to amounts paid by the company under a compensation plan or agreement that existed before the company became public (in the case of an IPO, this relief applies only to the extent that the compensation arrangement was disclosed in the prospectus). This transition relief applies even after the end of the transition period with regard to compensation recognized because of the exercise of a stock option or stock appreciation right, or the substantial vesting of restricted property, so long as the award was granted before the end of the transition period. The proposed regulations clarify that this transition rule does not apply to any other form of stock-based compensation. For example, compensation under a restricted stock unit or phantom stock arrangement must be paid or settled, as opposed to merely granted, before the end of the transition period to be eligible for transition relief.

Comments on these proposals may be submitted to the IRS until September 22.

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