

## Corporate & Financial Weekly Digest

July 8, 2011 by [Daniel B. Lange](#)

### IRS Proposes Regulations Clarifying 162(m) Compensation Deduction Rules

*Co-authored by [Michael R. Durnwald](#)*

The Internal Revenue Service recently issued proposed changes to the compensation deduction rules under Section 162(m) of the federal tax code. Section 162(m) generally limits a public company's compensation deduction with respect to its top executives to \$1 million per executive per tax year. If adopted, the proposed changes would clarify two details related to certain exceptions to the Section 162(m) deduction limit discussed below.

To the extent it is considered "performance-based," compensation is exempt from the \$1 million deduction limit of Section 162(m). Stock options and stock appreciation rights (SARs) are only able to be considered "performance-based compensation" if certain requirements are met. One such requirement dictates that the plan under which an option or SAR is granted must specify the maximum number of options or SARs an employee may receive during a specified period of time. The proposed changes clarify that the plan must state a per-employee limit (e.g., 100,000 shares per any 3-year period) to qualify the options and SARs as "performance-based compensation." If a plan only states an aggregate limit on the maximum number of shares that can be granted under the plan, the options and SARs will not qualify as "performance-based compensation" for purposes of Section 162(m).

The Section 162(m) regulations contain special rules that exempt certain payments from the Section 162(m) requirements if they are paid by a company that transitions from privately held to publicly held. One of these rules generally exempts compensation paid pursuant to a plan or agreement that existed prior to the company becoming publicly held for a limited period of time after the company becomes publicly traded (Transition Period). Under this exemption, compensation stemming from exercise of an option or SAR, or vesting of restricted stock, granted during the Transition Period is also exempt, even if such exercise or vesting occurs after the Transition Period. Practitioners have previously questioned whether this relief is also available for restricted stock units and phantom stock awards. The IRS's proposed changes clarify that such relief would not apply to restricted stock units or phantom stock. Thus, only restricted stock units and phantom stock paid during the Transition Period would be exempt from Section 162(m) under the special transition rules. If such an award is granted during the Transition Period, but paid after the Transition Period, it is subject to the \$1 million deduction limit of Section 162(m).

The IRS is currently soliciting comments about these proposed changes and indicated that they will be effective following publication of final changes. The proposed rules can be found [here](#).

Katten Muchin Rosenman LLP

Charlotte Chicago Irving London Los Angeles New York Washington, DC