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Final IRS Regulations Under Section 162(m) Will Impact Transition Rule Applicable to Newly Public Companies

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On March 31, 2015, the IRS issued final regulations under Section 162(m), the tax code provision which limits the deduction for compensation paid to certain public company executive officers. As signaled by the proposed regulations published in 2011 (described here in an earlier MoFo client alert), the final regulations reflect the IRS' new and more restrictive interpretation of the transition rule that applies to the preexisting equity plans of private companies that become public. The final regulations also reinforce the rule that individual award limits must be stated in a Section 162(m)-compliant equity plan.

BACKGROUND

Section 162(m)

Section 162(m) generally disallows a deduction for annual compensation in excess of $1,000,000 paid to a "covered employee" (the principal executive officer (the CEO) and the three highest paid executive officers other than the principal executive officer or the principal financial officer of a public company). Compensation for this purpose generally includes all remuneration for services performed by the covered employee, whether or not the services were performed during the same taxable year.

Qualified "performance-based" compensation, which is payable solely upon attainment of pre-established, objectively determinable performance goals pursuant to a shareholder-approved plan, is exempt from the $1,000,000 deduction limitation.

Transition Rule for Companies Going Public

The Section 162(m) regulations provide that in the case of a private company that becomes publicly held, the $1,000,000 deduction limit generally does not apply to any remuneration paid under any plan or arrangement that existed prior to the company becoming publicly held. For companies that become publicly held through an initial public offering (an IPO), the transition relief applies only to the extent that the prospectus accompanying the IPO disclosed information of existing compensation plans or arrangements.

A company going public may rely upon the transition rule until the earliest of: (i) the expiration of the plan or agreement; (ii) the material modification of the plan or agreement; (iii) the issuance of all stock and other compensation that has been allocated under the plan; or (iv) the first meeting of the shareholders after either the close of the third calendar year following the calendar year the company became publicly held through an IPO (or the close of the first calendar year following the calendar year in which the company became publicly held other than through an IPO).

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Treatment of RSUs and Phantom Stock Under the Final Regulations

Existing regulations provide that the transition relief applies to any compensation received pursuant to the exercise of a stock option or stock appreciation right, or the substantial vesting of restricted property granted under a plan or agreement if the grant occurs during the transition period. These awards could be exercised or vest after the transition period and retain their transition period protection. The final regulations clarify that this application of the transition rule applies only to options, stock appreciation rights, and restricted stock. In contrast, restricted stock units and phantom stock are only protected if actually settled or paid during the transition period. Although described as a "clarification," the final regulations provide that this portion of the final regulations is effective with respect to RSUs and phantom stock granted after the publication of the final regulations on March 31, 2015, suggesting that reliance on the transition rule for restricted stock units and phantom stock granted before that date is permissible.

Maximum Number of Shares with Respect to Which Options or Stock Appreciation Rights May Be Granted to Individual Employees

Under the final regulations, the IRS also reiterated that specific per-employee limits are required under Section 162(m) with respect to plans authorizing the grant of options or stock appreciation rights. A plan must not only specify the aggregate maximum number of shares that may be granted, but also contain a specific per-employee limitation on the number of options or stock appreciation rights that may be granted under the plan during a specified period. This requirement may be satisfied with a per-person limit on all equity based awards during a specified period.

CONCLUSION

Public companies operating within the transition period should consider their grant practices in light of the proposed regulations. Going forward, newly public companies may wish to limit their transition period grants to options, stock appreciation rights, and restricted stock. Restricted stock can often be structured to have the same economics as RSUs or phantom stock.

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