
Final Section 162(m) Regulations Clarify Transition Rules for Newly Public Companies and the Per Participant Limit Requirement

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Following the issuance of proposed regulations in June 2011, the Internal Revenue Service issued [final regulations](#) on March 30, 2015 clarifying certain exceptions to the compensation deduction limitation imposed by Section 162(m) of the Internal Revenue Code. Section 162(m) imposes a \$1 million annual limit on the compensation deduction permitted a public company employer for compensation paid to its CEO and its three most highly paid officers other than the CEO and CFO. However, exceptions to the deduction limitation exist for certain compensation paid by newly public companies and for "performance-based compensation." The final regulations, which became effective on April 1, (1) reiterate the IRS's position in the proposed regulations that the transition relief for newly public companies is limited to compensation attributable to options, stock appreciation rights and restricted stock, but not restricted stock units (RSUs) and (2) clarify the rules relating to the equity incentive plan per participant limit necessary for compensation attributable to options and stock appreciation rights to qualify as "performance-based compensation." None of the changes made by the final regulations are intended to be substantive changes to the requirements of the Section 162(m) regulations previously in effect.

Restricted Stock Units Granted During Transition Period

Although Section 162(m) applies to all public company employers, the rules provide that when a corporation first becomes publicly held the compensation paid pursuant to a plan or agreement that existed while the company was privately held will not be counted against the Section 162(m) deduction limitation if certain requirements are met. This transition relief expires on the earliest of (i) the expiration of the plan or agreement; (ii) a material modification of the plan or agreement; (iii) the issuance of all employer stock and other compensation that has been allocated under the plan or agreement; and (iv) for a company that goes public in an IPO, 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 occurs. The regulations under Section 162(m) explicitly apply this transition relief to any compensation received (whether during or after the transition period) pursuant to the exercise of a stock option or stock appreciation right or the vesting of restricted stock granted under a previously existing plan or agreement during the transition period; however, until

now, the regulations were silent with respect to the application of the transition relief to RSUs. The final regulations make clear that the compensation resulting from RSUs or other phantom stock arrangements granted after April 1 during a company's transition period under a previously existing plan or agreement is not eligible for the same relief. Therefore compensation under any such arrangements must be actually paid, rather than just granted, on or before the end of the transition period in order to escape the application of the Section 162(m) deduction limitation.

Equity Plan Per Participant Limit Applicable to Options and Stock Appreciation Rights

Companies must satisfy a number of requirements in order for the compensation attributable to stock options and stock appreciation rights to constitute "performance-based compensation" that is exempt from the Section 162(m) deduction limitation. Among them is the requirement that the equity incentive plan pursuant to which the award is granted specify the maximum number of shares with respect to which options or rights may be granted during a specified period to any employee. To the extent there was doubt on the matter, the final regulations make clear that plans cannot satisfy this per participant limitation requirement merely by providing an aggregate maximum number of shares that may be granted under the plan. Instead, the plan must separately specify a maximum per participant limit on the number of options or rights that may be granted in a specified period. In a departure from the proposed regulations, the final regulations make clear that the per participant limit requirement may be satisfied if the plan specifies an aggregate maximum number of shares with respect to which stock options, stock appreciation rights, restricted stock, RSUs and other equity-based awards (i.e., not just options and stock appreciation rights) that may be granted to any employee during a specified period. This rule applies to compensation attributable to stock options and stock appreciation rights that are granted on or after June 24, 2011.

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