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AMENDMENT TO SECTION 162(M) REGULATIONS

On March 31, 2015, the Treasury Department and the IRS issued final amended regulations under Section 162(m) to clarify that (1) stock plans must provide individual limits; and (2) RSUs granted by IPO companies must be paid prior to the end of the special transition period. Although many practitioners have been operating in accordance with the rules since they were proposed in 2011, all companies should confirm their stock plans comply and companies that are pre-IPO or recently had an IPO and are still within their transition period should review the final rules in order to make appropriate planning decisions with respect to upcoming equity awards.

Background. Generally, compensation paid by a publicly-traded corporation to its chief executive officer and three other highest compensated officers (other than the chief financial officer) is not tax deductible to the extent the officer's compensation exceeds $1 million per year. This limitation is subject to certain exemptions, including an exemption for "qualified performance-based compensation" (which is compensation that meets a number of requirements set forth in the regulations under Section 162(m) of the Internal Revenue Code) as well as an exemption for compensation under a plan or agreement that existed when the corporation was not publicly held.

On March 31, 2015, final regulations were published under Section 162(m) amending the existing regulations that address both of these exemptions. Specifically, the final amended regulations provide that (i) stock-based compensation plans must provide a limit on the maximum number of shares for which an individual employee may receive options or stock appreciation rights and (ii) restricted stock units (RSUs) are treated differently (and less favorably) than restricted stock for purposes of the special transition relief for companies that become publicly held.

The proposed amendments addressing the exemptions were published on June 24, 2011. The final amended rules adopt the proposed regulations with one modification, which provides additional transition relief for RSUs and is described in more detail below.

Maximum Share Limitation. One of the general requirements for performance-based compensation is that awards be issued pursuant to a shareholder approved plan and that, with respect to equity awards, the plan specify the maximum number of awards that can be issued to an employee during a specified time period. Prior to the issuance of the proposed amendments, some legal counsel took the view that an aggregate limit on the shares that could be issued under the term of the plan could also serve to satisfy the per-employee limitation in the case of stock options and stock appreciation rights (SARs).

The final amendments provide that the individual limit rule applies to stock options and SARs. The amendments also provide that the individual limit requirement will be satisfied if the plan specifies an aggregate maximum number of shares with respect to which options, SARs, restricted stock, RSUs and other equity-based awards may

be granted to any individual employee during a specified period. Since the vast majority of stock plans already include individual limits, the impact of this amendment is expected to be inconsequential for most companies.

The clarifications apply to compensation attributable to options and SARs that are granted on or after June 24, 2011.

IPO Company Equity Grants. In the case of a non-public corporation that becomes a publicly held corporation, the $1 million deduction limitation does not apply to compensation paid under a plan or agreement that was in effect when the corporation was not publicly held (so long as the IPO prospectus provides adequate disclosure). This relief is available only during a reliance period, which ends at 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 allocated under the plan or agreement, or (iv) the first meeting of shareholders to elect directors that occurs after the third calendar year following the year of the IPO (or if no IPO, after the first calendar year following the calendar year the corporation became public).

A special rule provides that the transition relief applies to compensation received pursuant to the exercise of options or SARs or the substantial vesting of restricted property if the grant occurred before the end of the applicable reliance period described above. This applies to any grants made prior to expiration of the transition period, no matter when the option or SAR is exercised or the restricted stock award vests. The final amendments provide that this relief is available only for stock options, SARs and restricted property and not for other equity-based awards such as RSUs or phantom stock arrangements (which were not referred to in the existing 162(m) regulations). The final amendments reject the argument that RSUs are sufficiently similar to restricted stock such that they should be treated in the same manner. Therefore, it is not enough that awards be granted before the expiration of the transition period -- compensation attributable to RSUs or phantom stock arrangements must be paid before the end of the reliance period to avoid being subject to the 162(m) deduction limitation. Although some companies have been operating in compliance with the proposed rules since 2011, in light of the final amendments, companies that are pre-IPO or recently had an IPO and are still within their transition period should review their stock plans and award agreements in order to make appropriate planning decisions going forward.

The final amendments apply to any remuneration that is otherwise deductible resulting from a stock option, SAR, restricted stock (or other property), RSU, or any other form of equity-based remuneration of IPO companies that is granted on or after April 1, 2015. This effective date reflects a suggestion made by commenters to apply the RSU rule only to RSUs granted after the publication of final amendments.

The final amendments do not address the treatment of RSUs in the case of subsidiaries of public companies that are spun-off (spin-offs are covered in a different paragraph and the spin-off paragraph has essentially the same language regarding restricted stock that the IRS felt it had to amend in the IPO paragraph). We expect that legal counsel will differ over how to interpret the impact of the failure to address the treatment of RSUs in spin-offs (i.e., some lawyers will take the position that the failure to address spin-offs means RSUs are treated in the spin-off context the same as restricted stock while others say the failure to amend was an inadvertent error and RSUs should not get better treatment in spin-offs than in IPOs).

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General questions about this summary can be addressed to Samantha Nussbaum in our Los Angeles office at 310-734-0145 or by email at snussbaum@fwcook.com. Specific questions should be referred to company counsel. Copies of this summary and other published materials are available on our website at www.fwcook.com.