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Proposed excess compensation regulations reflect continued stricter application of statutory requirements

The IRS has released proposed amendments to the regulations under section 162(m), which limits the deduction that public companies may take for compensation paid to the CEO and the top three executives to $1 million each. The new proposed regulations are intended to clarify two issues under section 162(m) relating to stock-based compensation.

Observation: It appears that the IRS is reconsidering its interpretation of section 162(m) in both regulations and private letter rulings. Companies should review their performance-based compensation plans in light of the IRS's stricter application of section 162(m).

The portion of the proposed regulations addressing performance-based plans with stock options and stock appreciation rights (SARs) would be effective June 24, 2011. The portion of the proposed regulations addressing stock-based compensation granted during the period in which a company transitions from private to public ownership would be effective on the date final regulations are published in the Federal Register.

Background

Section 162(m) provides that a corporation cannot deduct compensation in excess of $1 million that is paid to any individual who is a "covered employee" as of the last day of the tax year. A covered employee is defined as the CEO officer and the three named executive officers whose compensation is reported in the corporation's proxy.

The deduction limitation does not apply to qualified performance-based compensation. Final regulations issued in 1994 also provide an exclusion for certain compensation paid after a private company becomes publicly traded.

Performance-Based Plans with Stock Options and Stock Appreciation Rights

Current regulations provide general rules for qualified performance-based compensation, including requirements that the plan be approved by shareholders, the grants must be made by a committee of outside directors, and the performance goal must state, in terms of an objective formula or standard, the method for computing the amount of compensation payable to the employee if the goal is attained.

The proposed regulations clarify that the plan must specify the maximum number of shares with respect to which options or SARs may be granted to any individual during a specified period. The regulations also require that this per-employee limit be disclosed to shareholders; if it is not, the plan does not meet the shareholder approval requirements. The preamble to the proposed regulations notes that the per-employee limit is provided for in the legislative history to section 162(m) as well as the preamble to the current final regulations.

The immediate effective date of this portion of the proposed regulations (June 24, 2011) likely reflects the IRS's view that the per-employee limit was set forth in the legislative history and the preamble to the current final regulations, so this clarification does not appear to be significant.

Observations: The proposed regulations require that a qualified performance-based plan specifically state the maximum number of shares with respect to which options or SARs may be granted. Therefore, a plan that provides for the total number of shares available for grants of all stock-based compensation, including options, SARs, restricted stock, and restricted stock units (RSUs), but that does not specifically provide the number of shares available for option and SAR grants, may not meet the requirements for a qualified performance-based compensation plan.

Public corporations should review stock option and SAR plans to ensure that the plans include a per-employee grant limit. If the plan does not provide for such a limit, a plan amendment and shareholder disclosure and approval of the limit are required.

Stock-Based Compensation Granted During the Private-Public Transition Period

Current regulations provide for a transition period for a private corporation that becomes public. Under these rules, if a plan or agreement existed while the corporation was not publicly held, the limits under section 162(m) do not apply with respect to certain compensation provided to covered employees during the transition period. That period ends on the earliest of:

- the expiration of the plan or agreement,
- the material modification of the plan or agreement,
- the issuance of all employer stock and other compensation that has been allocated under the plan or agreement, or
- 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 initial public offering (IPO) occurs or, if the corporation becomes

publicly held without an IPO, the first calendar year following the calendar year in which the corporation becomes publicly held.

The 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" that existed before the corporation become publicly held "if the grant occurs on or before the earliest of the events" that result in the end of the transition period.

The proposed regulations clarify that the list of options, SARs, and restricted stock is a restrictive list and that the rule does not apply to phantom stock plans, restricted stock units, or other forms of stock-based compensation. Thus, the deduction for compensation paid under a phantom stock plan or the transfer of stock under an RSU must arise during the reliance period (and otherwise meet the requirement for the transition period relief) in order to be excluded from section 162(m). The preamble to the proposed regulations notes that this issue was examined prior to the issuance of the current final regulations and the IRS did not expand the exclusion at that time.

The change to the public-to-private transition period rules is effective on the date that final regulations are published in the Federal Register. Comments and requests for a public hearing on the proposed regulations must be filed by September 22, 2011. It is possible that this rule will be finalized, and thus effective, shortly after that date.

***Observation**:* The delayed effective date may not provide taxpayers with much relief if the regulations are finalized in 2011. It also raises questions on how the IRS would apply the regulations to compensation that is granted under the current final regulations, which the IRS believes are unclear, but is paid and deductible after the effective date.

Stricter Application of Section 162(m)

The new proposed regulations reflect the latest action taken by the IRS to tighten the application of section 162(m).

The proposed limitation on application of the public-to-private transition rule is a change in the IRS position as previously evidenced in private letter rulings. In PLRs 200406026 and 200449012, the IRS took the position that a restricted stock unit, a promise to deliver stock in the future after vesting requirements were met, was the economic equivalent of the grant of restricted stock. The rulings concluded that compensation related to the RSUs was excluded from section 162(m) as long as the RSU was granted during the reliance period even if the related deduction arose after the end of the reliance period. The new proposed regulations reverse the position taken in the 2004 PLRs.

Similarly, in 2008, the IRS issued a PLR and a Revenue Ruling overturning several earlier private letter rulings under section 162(m). Rev. Rul. 2008-13 held that compensation paid to an executive is not qualified performance-based compensation even if the compensation is paid on the attainment of the performance goal, if the plan or agreement provided that the compensation could have been paid before attainment of the goal if the executive's employment was terminated without cause or for good reason or if the executive retired. Those rulings reversed the position taken by the IRS in two prior private letter rulings. The IRS also limited the definition of an outside director in Revenue Ruling 2008-32, which held that a non-employee director who was chosen to serve as the interim chief executive officer and who served for less than 12 months could not later serve as an outside director for purposes of section 162(m).

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