

Meridian Client Update

IRS and Treasury Department Issue Final Regulations on Section 162(m)

On March 31, 2015, the Internal Revenue Service and Treasury Department issued final amended regulations under Section 162(m) of the Internal Revenue Code (the “Code”) to clarify that (1) stock plans must provide per-employee limits for stock options and stock appreciation rights to qualify as performance-based compensation exempt from the Section 162(m) deduction limit, and (2) restricted stock units (“RSUs”) granted by IPO companies must be paid prior to the end of the special transition period. The final regulations are similar to the proposed regulations (issued in June 2011), with slight modifications.

Maximum Share Limit per Employee

Code Section 162(m) precludes the deduction by any public company for compensation paid to any “covered employee” (i.e., proxy-disclosed officers other than the CFO) to the extent that the compensation for the taxable year exceeds \$1 million (“Deduction Cap”). However, the Deduction Cap does not apply to “qualified performance-based compensation.” Stock options or stock appreciations rights (SARs) generally are treated as qualified performance-based compensation, provided that such awards are (i) approved by a compensation committee composed solely of independent directors, (ii) not issued at a discount (i.e., the exercise price may not be less than the fair market of a company’s share price on the date of grant) and (iii) granted under a shareholder-approved plan that specifies the maximum number of options and SARs that may be granted to any employee during a specified period.

Prior to the issuance of the proposed regulations, some practitioners took the position that an aggregate limit on the number of shares that could be issued under an equity plan during its term could also serve to satisfy the requirement of a maximum limit on grants to employees under the plan. The final regulations clarify the requirement that an equity plan under which options or SARs are granted must specify the maximum number of options and SARs that **may be granted to any individual employee** during a specified time (e.g., a calendar year, term of plan). Thus, under the final regulations, a plan that states an aggregate maximum number of shares that may be granted under the plan but does not contain a specific per-employee limitation on the number of options or SARs that may be granted would **not** qualify for the performance-based compensation exception to Code Section 162(m).

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

RSUs Paid by Companies that Become Publicly Held Through an IPO

Section 162(m) generally provides that when a corporation becomes publicly held, the Deduction Cap “does not apply to any remuneration paid pursuant to a compensation plan or agreement that existed during the period in which a corporation was not publicly held.” A corporation may rely on this exemption from the Deduction Cap until 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 or (iv) 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 an initial public offering occurs or, in the case of a privately held corporation that becomes publicly held without an IPO (e.g., certain spin-offs), the first calendar year following the calendar year in which the corporation becomes publicly held (“transition period”). The exemption applies to any compensation received pursuant to the exercise of a stock option or SAR, or the substantial vesting of restricted stock, granted under a plan or agreement if the grant occurs on or before the earliest of the events specified above.

Consistent with its proposed regulations, the IRS final regulations provide that exemption from the Deduction Cap is available **solely** for stock options, SARs and restricted property and **not** for other equity-based awards such as RSUs or phantom stock arrangements. Some practitioners had argued that the exemption should also be available for RSUs granted before the expiration of the transition period because RSUs are economically similar to restricted stock. The final regulations do not adopt that treatment. Consequently, compensation attributable to RSUs or phantom stock arrangements must be **settled or paid** before the end of the transition period to be exempt from the Deduction Cap. This rule applies to RSUs granted on or after April 1, 2015 (i.e., the date of publication of the final amendments).

Meridian comment. Most public companies already include per-employee limitations in their equity compensation plans approved by shareholders. Consequently, the clarification in the final regulations regarding the maximum share limitation per employee is not expected to require many companies to modify their existing equity compensation plans to comply with its requirements.

Under the final regulations, a company that granted RSUs and phantom stock arrangements before April 1, 2015 and during its transition period but prior to April 1, 2015 and which settle or pay such awards after the end of the transition period is able to claim a tax deduction with respect to those awards, assuming that the other applicable requirements of Section 162(m) have been satisfied. A company that is contemplating going public or that is considering granting full-value awards during its transition period should be mindful of the tax implications. In such circumstances, restricted stock may be more appealing than RSUs in order to maximize tax deductibility, particularly if the company expects to grant awards with long vesting schedules or anticipates a short transition period.

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The *Client Update* is prepared by Meridian Compensation Partners’ Technical Team led by Donald Kalfen. Questions regarding this Client Update or executive compensation technical issues may be directed to Donald Kalfen at 847-235-3605 or dkalfen@meridiancp.com.

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