



New Proposed Rules under IRC Section 162(m)

July 14, 2011

The Internal Revenue Service (the “IRS”) has proposed regulations regarding three elements of its existing regulations under Section 162(m) of the Internal Revenue Code of 1986, as amended (the “Code”) with respect to stock-based compensation. Generally, Section 162(m) of the Code imposes a corporate deduction limit of \$1 million annually on certain compensation paid to certain employees of public companies (generally the named executive officers of the company listed in the proxy, other than the principal financial officer). Section 162(m) of the Code features a number of widely used exemptions to this deduction limit, including (1) with respect to non-public entities which become public entities, equity compensation granted during a limited transition period pursuant to a plan or agreement in place prior to a company becoming publicly held (whether through an initial public offering of its equity securities or otherwise) and (2) compensation that meets the criteria of “qualified performance based compensation.” The proposed regulations clarify the application of these two exemptions as described more fully below.

LIMITATION ON AVAILABILITY OF TRANSITION RELIEF FOR RESTRICTED STOCK UNITS AND PHANTOM STOCK

When a company becomes publicly held, the current regulations under Section 162(m) of the Code provide relief from compliance with the regulations during a limited transition period after the company becomes publicly held. During this transition period, subject to meeting certain disclosure requirements if the company became public in an initial public offering, compensation paid and equity awards granted pursuant to a plan or agreement that existed when the company was privately held will not be subject to the deduction limit. The transition period lasts until the earliest to occur of: (i) the expiration of the plan or agreement, (ii) a material modification to the plan or agreement, (iii) the issuance of all employer stock and other compensation allocated under the plan, or (iv) the first shareholders’ meeting to elect directors that occurs after the end of the third calendar year following the year of the initial public offering of the company’s equity securities, or if there was no initial public offering, the first calendar year following the year the company became publicly held. The current regulations specify that the transition relief will apply to stock options, stock appreciation rights and restricted property granted during this transition period, even if such awards are exercised or become vested after the transition period ends. This common sense approach is designed to ensure that options and stock appreciation rights can be held and exercised beyond the transition period (and restricted property (e.g., restricted stock) can vest after the transition period), without any loss of deductibility by the company.

In private letter rulings (e.g., PLR 200406026 and PLR 200449012) the IRS has previously acknowledged that this same approach should apply to restricted stock units that provide for a delayed delivery or vesting date after the transition period. Thus, for example, under such prior rulings, restricted stock units that were “granted” during the transition period but which settled and were “paid” after the end of the transition period would be exempt. Unfortunately,

the IRS's "clarifying" proposed rule takes a contrary view. Under the proposed rule, compensation derived from restricted stock units and phantom shares will **not** qualify for transition relief if the settlement or payment date of such awards occurs after the end of the transition period (although it would apply to the extent the awards are settled or paid prior to the end of the transition period).

This is a significant change that could result in a loss of deduction for many restricted stock unit and phantom equity programs for companies that have already gone public. Moreover, companies that relied on the private letter rulings in structuring restricted stock unit or phantom share grants that defer settlement or payment beyond the year in which vesting occurs may not be able to modify these grants to provide for settlement or payment during the transition period because the terms of these types of deferred compensation arrangements (such as the timing of settlement) generally cannot be modified without incurring additional taxes under Section 409A of the Code.

MAXIMUM SHARE LIMITATION AND SHAREHOLDER APPROVAL REQUIREMENT CLARIFICATION

The proposed regulations clarify that stock option and stock appreciation rights plans must specify a maximum number of shares or rights that can be granted to any individual employee during a given period in order to satisfy the qualified performance-based compensation exemption. This is not a meaningful change for most companies, as practitioners generally understood this to be the case. Accordingly, a plan that merely contains an aggregate maximum number of shares that may be granted under the plan (which is generally included for reasons in addition to Section 162(m) of the Code), but does not contain a per-employee limitation with respect to stock options and stock appreciation rights, will not qualify as a plan providing for qualified performance-based compensation. In addition, the proposed regulations clarify that, in the case of stock options and stock appreciation rights, the disclosure that is required to be provided to the company's shareholders in order to use the qualified performance-based compensation exemption must include (i) the maximum number of shares for which grants of stock option and stock appreciation rights may be made to each individual employee during a specified period and (ii) the exercise price of such awards (e.g., fair market value on the date of grant).

PRACTICAL CONSIDERATIONS

As a result of the proposed regulations, companies should reexamine their equity plans to ensure compliance with these proposals. Companies considering an initial public offering may wish to impose earlier settlement/payment dates for restricted stock unit and phantom share programs or use restricted stock, stock options or stock appreciation rights in lieu of restricted stock units and phantom shares. Public companies that relied on the transition relief exemption for restricted stock unit or phantom share grants should consider whether their plans can be modified to comply with these proposed regulations (or should analyze whether certain payments may not be deductible if these regulations become effective). In addition, all public companies should confirm that their equity incentive plans contain a separate limit on the number of shares that may be granted to an individual as stock options or stock appreciation rights during a given period (and, if not, such plans should be amended) and that any

shareholder disclosure made for purposes of Section 162(m) that relates to stock options or stock appreciation rights includes the exercise price determination for such types of awards.

EFFECTIVE DATE

Following the public comment period ending on September 22, 2011, the new rules regarding transition relief for restricted stock units and phantom stock will become effective for taxable years ending on or after the date the Treasury Department adopts these proposals as final regulations. As a result, there appears to be no transition relief available for companies that previously relied on the private letter rulings referenced above. The “clarifying” regulations regarding maximum share limits and related disclosure requirements for awards of options and stock appreciation rights became effective as of June 24, 2011.

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