Final Regulations Clarify and Streamline Section 162(m) Exemptions

On March 31, 2015, the IRS issued final regulations clarifying two exemptions from Section 162(m) of the Internal Revenue Code ("Section 162(m)"), which generally prohibits deductions by public companies for compensation paid to "covered employees" (generally, the CEO and the next three most highly compensated individuals, excluding the CFO) in excess of $1 million.

Given the final regulations, private companies that may become public should exercise caution with respect to vesting conditions that extend beyond the applicable transition period and may need to rethink granting RSUs altogether.

Transition Period Exemption

The final regulations limit the scope of certain transitional relief that exempts from Section 162(m) certain compensation paid by new public companies pursuant to a plan or agreement that existed when the company was private. Consistent with proposed regulations issued by the IRS in 2011, but contrary to prior guidance issued in private letter rulings, the final regulations provide that restricted stock units ("RSUs") issued by new public companies will only qualify for transitional relief if settled during the applicable transition period.[1] This is in contrast to the treatment for options, stock appreciation rights ("SARs"), and restricted stock awards, which qualify for the exemption if granted during the applicable transition period, even if vesting and/or exercise occurs following such period. Given the final regulations, private companies that may become public should exercise caution with respect to vesting conditions that extend beyond the applicable transition period and may need to rethink granting RSUs altogether. As an alternative to RSUs that vest and payout after the end of the transition period, newly public companies can grant restricted stock, which provides the same economics but is subject to the more favorable transition rules.

Performance-Based Pay Exemption

The final regulations also clarify the application of the performance-based pay exemption requirements to options and SARs, which generally will be deemed exempt from 162(m) under more lenient rules as compared to the performance-based pay exemption rules applied to equity awards generally. All equity awards, including options and SARs, qualify as performance-based pay if, among other things, they are granted pursuant to a plan that specifies a per-employee limitation on the aggregate number of shares with respect to which equity awards may be granted to an individual in a specified time period (the "per-employee limitation"). Based on previous guidance, many practitioners believed that the performance-based pay exemption rules required that the relevant plans include a separate per-employee limitation with respect to both equity awards in general and options and SARs specifically. However, the final regulations clarify that a single per-employee limitation with respect to equity awards in

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general can also be relied upon for purposes of the more narrow performance-based pay exemption provided to options and SARs, which should reduce the likelihood of foot fault violations of the option and SAR rules.

1 The transition period lasts until the first shareholder meeting that occurs during (i) the fourth year following the year of an IPO or (ii) for companies that go public other than via an IPO, the first shareholder meeting that occurs during the second year following the year in which the company goes public. The transition relief period will end earlier than described above if the relevant plan or agreement expires or is materially modified, or if the compensation or employer stock allocated thereunder is exhausted.

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