

IRS issues final regulations on key executive compensation issues under Section 162(m)

The IRS has issued final regulations ([TD 9716](#)) that settle two key issues under IRC §162(m) – first, whether an individual share limit is necessary for equity compensation to be exempt from IRC §162(m) and, second, how the so-called IPO transition rule applies to restricted stock units (RSUs) and certain other equity compensation. The final regulations adopt regulations proposed in 2011 (REG-137125-08) with a few modifications.

Background

IRC §162(m) generally limits a public corporation's deduction for the compensation of each "covered employee" to \$1 million per year, unless the compensation qualifies as "performance-based compensation." The "covered employees" are the CEO and next three highest paid executive officers (other than the CFO) of the public corporation as of the last day of the tax year.

For stock options and stock appreciation rights (SARs) to be performance-based compensation, the original final regulations specified that, among other requirements, the plan must state "the maximum number of shares with respect to which options or rights may be granted during a specified period to any employee." Similarly, the regulations provided that, for purposes of satisfying the shareholder disclosure and approval requirements for performance-based compensation, "disclosure would be required of the maximum number of shares for which grants may be made to any employee." Nonetheless, some argued that it was not clear whether these requirements could be satisfied by simply providing an aggregate maximum share limit for all the covered employees. Thus, the IRS issued the 2011 proposed regulations to clarify that an aggregate limit for all covered employees does not satisfy this requirement. It also clarified that, for shareholder disclosure purposes, the individual limit requirement applies to all equity-based compensation, not just to stock options and SARs.

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Ernst & Young LLP insights

Some taxpayers have been arguing since the issuance of the proposed regulations that the clarification of the individual limit essentially validated the use of an aggregate limit to satisfy IRC §162(m) prior to the proposed regulations being finalized.

The IRS discussion in the preamble to the regulation undercuts this argument, making it clear that it views the clarification on this point as not being substantive.

In rejecting commentators suggestions regarding the effective date of this provision, the IRS points to substantial pre-existing authorities stating that an aggregate limit was not sufficient.

The regulations under IRC §162(m) provide a transition rule for companies that go from being private (and exempt from IRC §162(m)) to being public. The original final regulations issued under IRC §162(m) provided that whether stock options, SARs and restricted stock are exempt under this transition rule depends on whether they are *granted* during a specified transition period, even if the related deduction arises after the transition period ends.

IRS private letter rulings, however, had extended this "date of grant" rule to RSUs, notwithstanding the specific regulatory language, as well as earlier preamble language rejecting the expansion of the date of grant rule to RSUs. Accordingly, the 2011 proposed regulations clarified that the "date of grant" rule does *not* apply to RSUs or any other compensation other than options, SARs and restricted stock.

The IRS received several written comments on the proposed regulations. The comments on the individual limit requirement all requested a transition rule or prospective effective date for the "clarification." These commenters reasoned that a transition period was appropriate because a plan providing for an aggregate share limit (but not an explicit per-employee share limitation) arguably satisfied the per-employee limitation requirement under the existing regulations because no individual employee may receive shares over the aggregate limit.

Some comments on the date of grant rule asked to extend the rule to RSUs. Others asked that the effective date for the clarification apply only to RSUs granted after the publication of final regulations and not merely to remuneration payable under an RSU after the date of publication.

Modifications made in final regulations

Individual share limit

The clarification in the new final regulations on the individual limit applies to compensation attributable to stock options and stock appreciation rights that are granted on or after June 24, 2011 (the date of publication of the proposed regulations). The IRS declined to adopt a transition rule or prospective effective date, emphasizing that the clarification to the individual limit "is not a substantive change." The IRS pointed out language in the original final regulations, legislative history and preamble to the 1993 regulations that had made it clear that an aggregate limit did not satisfy the performance-based compensation requirements.

For example, the preamble to the 1993 Treasury Regulations stated: "Some have questioned why it would be necessary for the regulations to require an *individual* [emphasis added] employee limit on the number of the shares for which options or stock appreciation rights may be granted, where shareholder approval of an aggregate limit is obtained for securities law purposes. The regulations follow the legislative history, which suggests that a per-employee limit be required under the terms of the plan." The preamble further explains that "a limit on the maximum number of shares for which individual employees may receive options or other rights is appropriate because it is consistent with the broader requirement that a performance goal include an objective formula for determining the maximum amount of compensation that an individual employee could receive."

Application of the date of grant rules to RSUs

The final regulations follow the proposed regulations in specifying that, under the private-to-public exemption, the date of grant rule applies only to stock options, SARs and restricted stock. The IRS did not adopt the suggestions to apply the date of grant rule to RSUs. The IRS did adopt, however, the suggestion to apply the rule only to RSUs granted on or after the date the final regulations were published in the Federal Register (March 31, 2015).

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