On June 24, the Internal Revenue Service (IRS) issued proposed regulations clarifying the scope of the performance-based compensation exception to the $1 million deduction limit under Internal Revenue Code (Code) Section 162(m). The proposed clarifications relate to the plan limits for stock option and stock appreciation right (SAR) grants and limit existing transition rules that provide a limited exemption from the Section 162(m) limits for private companies that become public. The proposed regulations go well beyond the typical "clarification" by further narrowing the rules under Section 162(m) in a material way with respect to the transition rule for private companies that become public, and raise many questions as to their potential effect on existing equity awards, including whether deductions could be retroactively disallowed. Seeking further insight into the scope of these proposed regulations, we have discussed many of these questions with the responsible government attorneys; what we have learned is described below.

Background

Section 162(m) generally limits a public company's tax deduction for compensation paid to certain highly compensated employees (the principal executive officer or
someone acting in that capacity and the three highest paid officers (other than the principal executive officer or principal financial officer)) to $1 million per year. This deduction limit does not apply to qualified performance-based compensation.[1] As a general matter, stock options and SARs qualify as performance-based compensation under Section 162(m) if (1) the grant or award is made by the organization's compensation committee; (2) the plan under which the option or SAR is granted states the maximum number of shares with respect to which options or SARs may be granted during a specified period to any employee; and (3) under the terms of the option or SAR, the amount of compensation the employee can receive is based solely on an increase in the stock value after the grant date.

**Per-Person Plan Limits for Option and SAR Grants**

The proposed regulations clarify that the plan under which the option or SAR is granted must state the maximum number of shares with respect to which options or SARs may be granted during a specified period to any "individual" employee. The intent of the clarification is illustrated in the conforming change to Example (9) of Reg. § 1.162-27(e)(2)(vii), which provides that if a plan states an aggregate maximum number of shares that may be granted but does not provide a specific per-employee limit on the number of options or SARs that may be granted during a specific period, any compensation attributable to the options or SARs granted under the plan would not be qualified performance-based compensation, and the Section 162(m) deduction limit would apply. The proposed regulations also make conforming changes to the shareholder approval requirements by requiring disclosure to shareholders of the per-person plan limit for options and SARs.

Omnibus plans (plans that offer multiple equity award types in addition to options and SARs) often include per-person limits on the number of performance-based awards that may be granted during a specified period without specifically providing separate per-person limits for options and SARs. As a result of the clarification set forth in the proposed regulations, some taxpayers were concerned that the lack of a separate per-person limit for options and SARs might cause those grants to fail to qualify as performance-based compensation under Section 162(m). We argued, in an informal comment filed on these proposed regulations, that a per-person limit on performance-based awards granted during a specified period effectively provides the maximum number of options or SARs that can be granted under the plan to any one employee and that the grant of any other type of equity award simply reduces the number of options or SARs that could be granted during the specified period (which is effectively the exercise of negative discretion in compliance with Section 162(m)).

We have been told that the IRS felt that this regulatory clarification was necessary because the IRS agents have seen "a lot" of plans that either have no per-person limit, or have one that is so vague that it effectively is not a limit (e.g., a limit "over the life of the plan"-with no stated life to the plan). We have been advised that these proposed regulations are not intended to mandate that every equity compensation plan tailor its "per person/per period" limit solely to options and SARs. We understand that the IRS intends to address this point in the Preamble of the final regulations. However, we have suggested instead that the IRS add an example to the final regulations because preambles are often overlooked, as evidenced by the second clarification in these same proposed regulations (discussed
below), where the 1994 Preamble of the final regulations said one thing but the IRS issued private letter rulings helpful to taxpayers that directly contradicted the Preamble. (Some clients may want us to file a formal comment on this issue.) If the IRS does not provide the requested clarification (either in the final Preamble or in the final regulations themselves), then, based on a literal interpretation of the proposed regulations, any plan that does not specifically provide the required per-person/per-period limit on options and SARs would fail to satisfy the performance-based compensation requirements under Section 162(m) (even if the plan provided a per-person/per-period limit on the number of performance-based awards generally).

**Effective Date and Resulting Impact.** This clarification is effective June 24, 2011, as discussed below. It appears that all option and SAR exercises on or after June 24, 2011 under a plan that does not provide the required per-person/per-period limit on options and SARs (or on performance-based awards generally) will not qualify as performance-based compensation. Although this result may seem harsh, it is supported by the prior guidance (and prior transition relief with respect to the per-person/per-period limit for plans that were approved by shareholders before December 20, 1993). See Treas. Reg. § 1.162-27(h)(3)(i). Accordingly, any public company plan without the required per-person/per-period limits must be amended and reapproved by shareholders prior to option and SAR exercises for the exercises thereunder to qualify as performance-based compensation under Section 162(m). It is possible that, to cure outstanding awards, the IRS would require shareholders to approve the outstanding awards, and in the event of nonapproval, such outstanding awards would be effectively void (similar to the shareholder approvals required under the golden parachute rules).

**Transition Rule for Private Companies That Become Public**

The second clarification made by these proposed regulations affects restricted stock units (RSUs) and phantom shares granted by private companies and payable after an IPO or an acquisition by a public company-and prevents the RSUs and phantom stock from qualifying for the Section 162(m) exemption under the transition rules for private companies that become public.

Under Treas. Reg. §1.162-27(f)(1), the $1 million deduction limit does not apply to any compensation plan or agreement that existed before the company became publicly held to the extent that the plan or agreement was disclosed in the IPO prospectus (if applicable). This exemption is available until the earliest of (1) the expiration of the plan or agreement; (2) the material modification of the plan or agreement; (3) the issuance of all employer stock and other compensation that has been allocated under the plan; or (4) the first shareholders meeting at which directors are elected that occurs after the close of the third calendar year following the calendar year in which the IPO occurs or, in the case of a privately held company that becomes publicly held without an IPO, the first calendar year following the calendar year in which the company becomes publicly held. The regulations offer a more generous rule for options, SARs, and restricted property (but not explicitly for RSUs or phantom shares), extending the exemption to any compensation received pursuant to the exercise of an option or SAR, or the substantial vesting of restricted...
property, granted before the end of the transition period. In contrast to the private letter rulings described below, however, the proposed clarification provides that RSUs and phantom shares are not covered by the special rule for options, SARs, and restricted stock. As a result, under the proposed regulations, RSUs or phantom shares that are granted during the transition period but that are paid after the transition period are subject to the Section 162(m) deduction limit.

This proposed clarification reverses two, possibly three, private letter rulings confirming that the special transition rule for options, SARs, and restricted property applies to RSUs. In Private Letter Rulings 200449012 (Dec. 3, 2004) and 200406026 (Feb. 6, 2004), the IRS acknowledged that an RSU is the economic equivalent of a grant of restricted stock that is subject to the same forfeiture conditions and transfer restrictions and ruled that payment with respect to RSUs granted prior to the end of the transition period is compensation that is not subject to deduction disallowance under Section 162(m). More recently, in Private Letter Ruling 200919020 (May 8, 2009), the IRS ruled that "stock-based compensation" received by an executive that was granted prior to the end of the transition period was not subject to the Section 162(m) deduction limitation. Private letter rulings expressly provide that the ruling is directed only to taxpayers who requested it and may not be cited or used upon as precedent. Nevertheless, taxpayers often rely on private letter rulings issued to other taxpayers, and do so at their own risk.

The IRS's rationale for this clarification is simple: RSUs and phantom shares are not specifically listed as items of stock-based compensation in the special transition rule for options, SARs, and restricted property, and thus are not covered by that rule. The Preamble to the proposed regulations provides that this clarification is consistent with the Preamble to the final 1994 Treasury Regulations, where the IRS and Treasury stated that it would not extend the relief provided for options, SARs, and restricted stock to cover other stock-based compensation. However, as discussed above, the IRS has issued private letter rulings that directly contradict this Preamble.

**Effective Date and Resulting Impact.** This clarification, if finalized in its current form, will be effective with respect to RSUs and phantom shares payable "on or after" the date the final regulations are published, regardless that the grants were made during the transition period. Companies that granted RSUs during the transition period after becoming public might have large compensation expenses that cannot be deducted if RSUs are not paid before the end of the transition period. The issue is greater for RSUs that are deferred compensation subject to Code Section 409A (i.e., RSUs that do not "vest and pay") because the company cannot accelerate the payment date of such RSUs (or rescind and replace such RSUs) without subjecting the employee to Section 409A taxes. To eliminate this unfairness, persons commenting on these proposed regulations likely will ask the IRS to either (1) provide that the proposed clarification will be effective only with respect to prospective grants on or after the date the final regulations are published or (2) permit grants that were made during any transition period that commences prior to the date the final regulations are published to be amended to accelerate the payment date without subjecting the employee to Section 409A taxes.

Assuming that the IRS does not provide such relief, we recommend that any
taxpayers covered by the transition rules who have been relying on the cited private letter rulings consider settling their RSUs before the end of the applicable transition period, if possible and consistent with Section 409A. In addition, taxpayers covered by the transition rules should consider these proposed regulations when granting RSUs during the transition period to ensure that RSUs are not granted to employees who may become subject to Section 162(m) or, if RSUs are granted to employees who may become subject to Section 162(m), that those RSUs are settled prior to the end of the transition period.

**Ambiguity Relating to the Effective Date**

The proposed regulations state that (1) the clarification relating to per-person limits on options and SARs is effective on and after June 24, 2011; and (2) the clarification that RSUs and phantom shares are not covered by the public-to-private transition rules (overriding the result of the above-cited private letter rulings) is effective "on or after" the date the final regulations are published. By contrast, the Preamble's explanation of the effective date states that these regulations are proposed to apply to "taxable years ending on or after" the date the final regulations are published. The government attorneys who worked on this project are aware of this inconsistency. We understand that the regulations were intended to be effective at the time provided in the proposed regulations, not on the effective date stated in the Preamble. Because the proposed regulations are clarifications of existing rules, the effective date with respect to the per-person/per-period limit on options and SARs is June 24, 2011. With respect to the clarification to the private-to-public transition rules, we understand that the new guidance is intended to be effective on or after the date the final regulations are published, in recognition that some taxpayers may have relied on the above-cited private letter rulings.

**Comment Period**

We intend to submit comments and encourage interested parties to consider doing the same. Even though taxpayers are cautioned not to rely on private letter rulings issued to other taxpayers, the proposed clarification to the private-to-public transition rule seems particularly unfair because it has the potential to subject the payment of currently outstanding RSU and phantom share grants to the Section 162(m) deduction limit in the event that the payment date cannot be accelerated under Section 409A to a date before the end of the transition period.

Comments and hearing requests on the proposed regulations are due by September 22, 2011.

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In recent years, the IRS has begun to audit public companies on Section 162(m) issues more and more. The proposed regulations are yet a further indication that the IRS is increasingly taking a narrower stance on Section 162(m) issues. For more information about the proposed regulations and Section 162(m) audits, please contact any of the Morgan Lewis attorneys listed below.
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[1]. The performance-based compensation exemption does not apply to employers participating in the Troubled Asset Relief Program and certain health insurers. See Code Sections 162(m)(5) and (6).

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