Client Alert: Proposed 162(m) Regulations Affect Deductibility of Equity-Based Compensation

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The Internal Revenue Service has issued proposed regulations under Section 162(m) of the Internal Revenue Code that affect the deductibility of equity compensation. Although these regulations are prospective only, they will become effective when adopted later in 2011.

Section 162(m) denies a corporate tax deduction for compensation payable by publicly held corporations to certain "covered employees" in excess of $1,000,000.

The proposed regulations clarify the application of Section 162(m) to stock options and stock appreciation rights and to equity-based compensation paid by companies that become publicly held.

Equity Plans Must Contain Explicit Per Employee Limit on Options, Appreciation Rights

Stock options and stock appreciation rights granted under a shareholder-approved equity plan generally are considered to be deductible performance-based compensation under Section 162(m).

The proposed regulations clarify that, in order for options or appreciation rights to be deductible under Section 162(m), equity plans must specify "the maximum number of shares with respect to which options or rights may be granted to each individual employee" and disclose to shareholders this limit and the methodology that will be used to set the exercise price of any option or appreciation right granted under the plan. Equity plans must already include an aggregate limit on the number of shares that may be awarded to all participants in order to comply with the federal securities laws.

Equity-Based Compensation for Newly Public Companies

Section 162(m) contains a special transition rule for companies that become publicly held. Under this transition rule, compensation from the exercise or vesting of stock options, stock appreciation rights and restricted stock granted before or shortly after a company becomes publicly held is excluded from the $1,000,000 threshold under Section 162(m), regardless of when exercise or vesting occurs.

Unfortunately, the proposed regulations clarify that this exception does not apply to other types of equity compensation, such as restricted stock units or phantom stock. As a result, restricted stock units and phantom stock granted by a company that becomes publicly held will not be deductible if settled or paid after the company becomes publicly held.

Actions Required

Publicly held companies and private companies that are thinking about a public offering should review their equity plans to determine whether they comply with the proposed regulations. Many equity plans already contain language limiting the number of shares that may be granted to any individual employee. If your equity plan does not contain this limit, the plan will need to be amended to preserve the deduction under Section 162(m) when the proposed regulations are finalized.

Also, newly public companies that are subject to Section 162(m) and have granted awards of restricted stock units, phantom stock or other types of equity-based compensation should consider whether the original grants met the requirements for exclusion from 162(m) (for example, were approved by an independent compensation committee and were granted under a shareholder approved plan). If not, the company should consider restructuring the awards to ensure their future deductibility.

Should you have any additional questions regarding these proposed regulations, please contact your Vorys attorney.

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