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IRS Revises Code Section 162(m) Rules

The IRS recently issued proposed regulations under Code section 162(m) to address two equity compensation issues. 76 Fed. Reg. 37034 (June 24, 2011). The IRS states that these proposed regulations are simply making clarifications on these issues. However, on one of the issues, the rule in the regulations is the opposite of the more taxpayer-friendly holding in two private letter rulings. This is the second instance in recent years where IRS guidance has taken a less taxpayer-friendly position on a section 162(m) issue than the Service had in private letter rulings. Thus, these proposed regulations provide further evidence of the IRS taking tougher positions on section 162(m) issues and the dangers of relying on private letter rulings, particularly in this area.

Background – Section 162(m) limits to \$1 million a publicly-traded company's annual deduction for compensation paid to a "covered employee." However, certain types of compensation are exempt from the \$1 million limit. Most importantly, "performance-based compensation" meeting a number of requirements is exempt from the limit. Thus, equity and other forms of variable compensation are often structured to qualify as "performance-based compensation."

Clarification of Options/SARs Limit – Regulations under section 162(m) contain a special rule whereby stock options and stock appreciation rights ("SARs") will be treated as meeting a key "performance-based compensation" requirement. In order to receive this special treatment, among other things, the plan under which the options or SARs are granted must contain a limit on the number of shares covered by such awards to any employee during a specified period. The proposed regulations clarify that this requirement will not be satisfied simply because the plan contains an overall limit on the number of shares that may be issued under the plan, i.e., the plan must contain a limit per individual employee as well. The proposed regulations also clarify that this per-employee limit must be included in the information approved by shareholders to meet a separate shareholder approval requirement for performance-based compensation.

IPO Transition Relief – The regulations under section 162(m) also contain an exemption for certain amounts awarded by a company during a transition period ending shortly after it becomes publicly traded. Specifically, amounts received pursuant to an award of options, SARs or restricted stock made during the transition period will be exempt from the \$1 million annual limit.

In the proposed regulations, the IRS states that this relief for amounts awarded during the transition period is limited to options, SARs and restricted stock. It does not apply to grants of other types of equity compensation, such as restricted stock units ("RSUs") or phantom stock. The IRS reached the opposite result in at least two private letter rulings, holding that the same transition relief did apply to RSUs. See PLR 200449012 (Dec. 3, 2004), PLR 200406026 (Feb. 6, 2004). Given the current popularity of RSUs, this could be a critical distinction.

According to the Preamble, these changes are to be effective for tax years ending on or after publication of final regulations. However, the proposed regulations actually state that (1) the per employee limit change is effective on June 24, 2011, and (2) the IPO change applies on the date final rules are published. Presumably, the discrepancy will be cleared up in the near future.

Comments may be submitted until September 22, 2011.

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