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Treasury Clarifies Performance-Based Compensation Exception Under the \$1 Million Deduction Limitation

Treasury proposes to clarify the requirements of two issues under the performance-based compensation exception to the \$1 million deductible compensation limit of Code Section 162(m). The proposed regulations make clear that the performance plan must state the maximum number of options or rights for each individual and that the special transition rule applies only to compensation received pursuant to a stock option, SAR, or restricted stock award. The special transition rule does not apply to restricted stock units and phantom stock.

Background

Section 162(m) of the Internal Revenue Code (Code) generally limits the annual deduction a publicly-held corporation may take for the compensation of the Chief Executive Officer (CEO) and the three other highest-paid executive officers to \$1 million each. In determining the compensation that is subject to the \$1 million deduction limit, the Code excludes performance-based compensation. For purposes of this test, the existing final regulations provide that stock options and stock appreciation rights (SARS) satisfy this standard only if, among other things, “the option or right under which the option or right is granted states the maximum number of shares with respect to which options or rights may be granted during a specified period to any employee.” (See Treas. Reg. Sec. 1.162-27(e)(2)(vi)(2).)

The existing final regulations also provide a special transition rule in the case of a private corporation that becomes publicly held through an initial public offering (IPO) or otherwise. Under the special transition rule, the \$1 million restriction does not apply to amounts paid pursuant to a compensation plan or agreement that existed prior to the IPO or other conversion. The transition period ends at the earliest of (1) the expiration of the grant or agreement being materially modified, (2) the material modification of the grant or agreement, (3) the issuance of all stock and other compensation allocated under the plan, or (4) the shareholder meeting after the third calendar year following the IPO (or if there is no IPO, the first full calendar year following the year the company became public). The special transition rule applies to stock options, SARS, and substantial vesting of restricted property. (See Treas. Reg. Sec. 1.162-27(f).)

Proposed Regulations

The Department of the Treasury (Treasury) proposed [regulations](#) that clarify two issues under the existing final regulations. First, the plan under which the option or right is granted must specify the maximum number of shares

with respect to which option or rights may be granted to any individual during that period. Otherwise the grant (and any compensation paid as a result) will not be considered to be performance-based pay and will be subject to the \$1 million deduction limitation.

BUCK COMMENT. *Although the annual limitation on the maximum number of shares was generally understood to be on an individual basis, some companies may not have documents that are in full compliance. Public companies should check their relevant plan documents for compliance and ensure they have appropriate limitations in place.*

The second issue covered by the proposed regulations is a clarification as to which plans the transition rules apply. The IRS makes it clear that the transition rules apply to stock options, SARs, and restricted stock and does not cover other plans such as restricted stock units (RSUs) or phantom stock.

BUCK COMMENT. *It appears that the second part of the proposed regulations constitutes a change in the Internal Revenue Service's (IRS) position. In two private letter rulings ([PLR 200406026](#) and [PLR 200449012](#)) the IRS allowed the special transition rule to apply even though RSUs were included in the covered compensation plans. Although PLRs provide reliance only to those requesting the PLR, many practitioners followed the liberal approach of the PLR.*

Effective Dates

The proposed regulations provide that the clarification of the first question (stating individual maximums) applies on or after June 24, 2011. The clarification of the second question (modification of the special transition rule) applies only after Treasury promulgates these rules as final regulations.

Conclusion

Both rules are referred to as clarifications, although the second change is also referred to as a modification (in the effective date provision). The proposed regulations do not address whether the IRS will be providing any type of relief program or whether it will pursue companies that interpreted the existing final regulations differently.

Buck's consultants are available to discuss the issues raised by the proposed regulations.

This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.