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For your information

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IRS Clarifies Treatment of Performance-Based Restricted Stock and Restricted Stock Units

Restricted stock and restricted stock units must satisfy certain requirements to be treated as performance-based compensation under Internal Revenue Code Section 162(m) and thus fully tax deductible by public companies. The IRS recently issued guidance on whether the dividends on restricted stock and the dividend equivalents on restricted stock units must separately satisfy the Section 162(m) requirements to be treated as performance-based compensation. Besides stand-alone stock compensation plans, other documents such as employment, retention, severance, and change-in-control agreements frequently contain equity compensation provisions. Public companies should review and, if necessary, amend existing plans and agreements to ensure that any grants of restricted stock or restricted stock units are structured to secure maximum tax advantages.

Background

Public companies generally may deduct, for federal income tax purposes, salaries or other compensation paid to their employees for services rendered. With certain exceptions, Section 162(m) of the Internal Revenue Code limits the deduction to $1 million annually for each “covered employee” (i.e., the corporation’s chief executive officer as of the close of the taxable year and the four highest compensated officers other than the CEO).

Generally, Section 162(m)’s deduction limit does not apply to qualified performance-based compensation. Compensation paid solely for meeting one or more preestablished, objective performance goals qualifies for the exception and thus is fully deductible notwithstanding the $1 million limit, provided the following conditions are satisfied:

- The board of directors or a compensation committee comprised solely of two or more outside directors establishes the performance goals under which compensation is to be paid.
- The material terms under which compensation is to be paid, including the performance goals, are disclosed to shareholders and approved by a majority vote before the compensation is paid.

- Before any payment is made, the compensation committee certifies in writing that the performance goals and other material terms were satisfied.

Whether compensation satisfies the performance goal requirements generally is determined on a grant-by-grant basis.

Grants of restricted stock and grants of restricted stock units can constitute qualified performance-based compensation under Section 162(m), but their tax treatment differs. Restricted stock represents a grant of company stock subject to a vesting schedule, and generally entitles the recipient to voting rights and to dividends declared on the stock. By contrast, restricted stock units (RSUs) represent a grant of the right to receive shares of fully vested stock in the future, but they generally do not provide voting rights or dividends prior to the issuance of actual shares.

Some companies provide cash payments for RSUs which are equivalent to dividends on the restricted stock declared between the grant date and vesting date (i.e., dividend equivalents). The IRS ruled previously that dividends on unvested restricted shares and dividend equivalents attributed to shares underlying the RSUs during this period are considered taxable compensation. After the restricted shares vest or the RSUs are settled in stock, any dividends paid are taxable as dividends and not as compensation.

Revenue Ruling 2012-19

In Revenue Ruling 2012-19, the IRS addresses the deductibility under Section 162(m) of dividends or dividend equivalents on performance-based restricted stock or RSUs. The revenue ruling clarifies that, to be excludible from the $1 million deduction limit, the payment of dividends or dividend equivalents must be conditioned on meeting the requirements applicable to performance-based compensation under Section 162(m). Performance goals may be the same as, or differ from, the goals applicable to the underlying restricted stock or RSU awards. If dividends or dividend equivalents are payable whether or not their performance goals are met, the dividends or dividend equivalents must separately satisfy the requirements under Section 162(m) to be treated as performance-based compensation.

The revenue ruling discusses two scenarios that illustrate when dividends and dividend equivalents that are separate and apart from the related restricted stock and RSU grants qualify as performance-based compensation.

In the first scenario, the dividends and dividend equivalents relating to performance-based restricted stock and RSU awards are not paid currently. Instead, they accumulate during the vesting period of the stock or RSU and are paid to the employee only if the restricted stock and RSUs vest. Because the dividends and dividend equivalents become vested and payable only if the performance goals underlying the restricted stock and RSU awards are satisfied, they also satisfy the performance goal requirements and may be treated as qualified performance-based compensation. As such, they are tax deductible even if they exceed the $1 million deduction limit in Section 162(m).

In the second scenario, the dividends and dividend equivalents relating to performance-based restricted stock and RSU awards are paid currently (i.e., at the same time dividends are paid on the company's common stock) whether or not preestablished performance goals are met. Because the dividends and dividend equivalents do not satisfy the performance goal requirements of Section 162(m), they are not treated as performance-based compensation whether or not the performance goals underlying the restricted stock and RSUs are met. As a result, they are subject to the $1 million deduction limit.

Conclusion

Although the revenue ruling is not surprising, it does provide a useful reminder to public companies to revisit their executive compensation plans and other agreements involving performance-based equity awards. Companies should carefully consider whether any amendments to their plans or agreements may be needed to ensure optimal tax advantages.

Buck Can Help

- Evaluate the impact of this guidance on your executive compensation plans, as well as employment, retention, severance, and change-in-control agreements
- Align pay with performance in equity compensation packages
- Structure cash- and equity-based incentive compensation plans to maximize corporate tax deductions
- Implement best pay practices for compensation design