

AN ALERT FROM THE BDO COMPENSATION & BENEFITS TAX PRACTICE

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► SUBJECT

PROPOSED REGULATIONS WOULD CLARIFY EXCEPTIONS TO \$1 MILLION TAX DEDUCTION LIMIT ON TOP OFFICERS' PAY

► SUMMARY

Recently-proposed Treasury regulations would clarify the section 162(m) \$1 million annual limitation on tax deductions for compensation paid to top corporate officers. The proposed regulations state that in order to be exempt from the limit, qualified performance-based compensation resulting from stock options and stock appreciation rights ("SARs") must state the maximum number of shares with respect to which options or rights may be granted to each individual employee. In addition, the proposed regulations would clarify the application of a key transition rule for non-publicly held corporations that become publicly held. When issued as final regulations, the clarifications relating to performance-based compensation would apply on or after June 24, 2011. However, the clarification relating to the transition rule for former non-publicly held corporations would apply on or after the date of publication of the final regulations.

BACKGROUND

Currently, with a few exceptions, section 162(m) provides a \$1 million tax deduction limitation for compensation paid by a publicly held corporation during any taxable year to a covered employee [the Chief Executive Officer and the three highest-paid officers (other than the Chief Executive Office and the Chief Financial Officer)].

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This limitation does not apply to some types of performance-based compensation, *i.e.*, compensation payable solely on account of the attainment of one or more performance goals, provided that certain other requirements are also met. For example, stock options will satisfy the performance-goal requirement if the grant or award meets the following requirements:

1. The grant or award is made by the compensation committee;
2. The plan 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 individual employee; and
3. Under the terms of the option or right, the amount of compensation the employee can receive is based solely on an increase in the value of the stock after the date of the grant or award.

MAXIMUM NUMBER OF SHARES TO AN INDIVIDUAL EMPLOYEE

Prop. Reg. § 1.162-27(e)(2)(vi)(A) clarifies that plans under which options or rights are granted must specify the maximum number of shares with respect to which options or rights may be granted to any individual employee during a specified period. If a plan states an aggregate maximum number of shares that may be granted but does not contain a specific per-employee limitation on the number of options that may be granted, any compensation resulting from stock options or rights granted under the plan would not be qualified performance-based compensation. The proposed regulations would make a conforming change to Example 9 of Treas. Reg. § 1.162-27(e)(2)(vii), as well as to Treas. Reg. § 1.162-27(e)(4)(iv), which relates to the disclosure of option grant details to shareholders of the corporation.

APPLICATION TO COMPANIES GOING PUBLIC

Under Treas. Reg. § 1.162-27(f)(1), if a non-publicly held corporation becomes publicly held, the \$1 million tax deduction limitation does not apply to any compensation paid under a compensation plan or agreement that existed while the corporation was not publicly held. If a corporation makes an initial public offering (“IPO”) of its stock, this exception applies only to the extent that the prospectus discloses information about its existing compensation plans or agreements and satisfies all applicable securities laws.

1. Corporations can rely on this transitional relief until the earliest of the following events occurs:
2. The expiration of the plan or agreement;
3. The material modification of the plan or agreement;
4. The issuance of all employer stock and other compensation that has been allocated under the plan; or

The first meeting of shareholders at which directors are to be 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 corporation that becomes publicly held without an IPO, the first calendar year after the calendar year in which the corporation becomes publicly held.

Under Treas. Reg. § 1.162-27(f)(3), this relief applies to any compensation received pursuant to the exercise of a stock option or SAR, or the substantial vesting of restricted property, granted under a plan or agreement if the grant occurs on or before the earliest of the events specified above.

The proposed regulation would modify Treas. Reg. § 1.162-27(f)(3) to state that no forms of stock-based compensation other than stock options, SARs, and restricted property are covered under Treas. Reg. § 1.162-27(f)(3). The proposed rules would provide that, in order to apply Treas. Reg. § 1.162-27(f)(1), compensation payable under a restricted stock unit arrangement or a phantom stock arrangement must be paid, and not simply granted, on or before the occurrence of the earliest of the events specified in Reg. § 1.162-27(f)(2) to get the transitional relief.

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