Client Alert.

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Proposed Regulations under Section 162(m) May Change Grant Practices of Recently Public Companies

By Michael T. Frank and Yong L. Yeh

On June 23, 2011, the IRS issued proposed regulations under Section 162(m), which limit the deduction for compensation paid to certain public company executive officers. The proposed regulations would significantly modify the transition rule that applies to the preexisting equity plans of private companies that become public. The proposed regulations also reinforce the rule that individual award limits must be stated in a Section 162(m) compliant equity plan.

BACKGROUND

Section 162(m)

Section 162(m) generally disallows a deduction for annual compensation in excess of $1,000,000 paid to a “covered employee” (the principal executive officer (the CEO) or one of the three highest paid executive officers other than the principal executive officer or the principal financial officer of a public company). Compensation for this purpose generally includes all remuneration for services performed by the covered employee, whether or not the services were performed during the same taxable year.

Qualified “performance-based” compensation, which is payable solely upon attainment of pre-established, objectively determinable performance goals pursuant to a shareholder-approved plan, is exempt from the $1,000,000 deduction limitation.

Existing Transition Rule for Companies Going Public

Current regulations provide that in the case of a private company that becomes publicly held, the $1,000,000 deduction limit does not apply to any remuneration paid under any plan or arrangement that existed prior to the company becoming publicly held. In the case of an initial public offering (an “IPO”), the transition relief applies only to the extent that the prospectus accompanying the IPO disclosed information of existing compensation plans or arrangements.

A company going public may rely upon the transition rule until the earliest of: (i) the expiration of the plan or agreement; (ii) the material modification of the plan or agreement; (iii) the issuance of all stock and other compensation that has been allocated under the plan; or (iv) the first meeting of the shareholders after either the close of the third calendar year following the calendar year the company became publicly held through an IPO (or the close of the first calendar year following the calendar year in which the company became publicly held other than through an IPO).

Treatment of RSUs and Phantom Stock under the Proposed Regulations

The IRS provided that the proposed regulations would limit the transition rule protection for equity-based plans to options, stock appreciation rights and restricted stock granted during the transition period. These awards could be exercised or vest after the transition and retain their transition period protection. In contrast, restricted stock units and phantom stock would be protected only if actually settled or paid during the transition period.

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Maximum Number of Shares with Respect to Which Options or Stock Appreciation Rights May Be Granted to Individual Employees

Under the proposed regulations, the IRS also clarified that specific per-employee limits are required under Section 162(m) with respect to plans granting options or stock appreciation rights. A plan must not only specify the aggregate maximum number of shares that may be granted, but it must also contain a specific per-employee limitation on the number of options or stock appreciation rights that may be granted under the plan during a specified period.

CONCLUSION

Public companies operating within the transition period should consider their grant practices in light of the proposed regulations. Pending finalization of the regulations, companies may wish to limit their transition period grants to options, stock appreciation rights and restricted stock. Restricted stock can generally be structured to have the same economics as RSUs or phantom stock.

If you have any questions, contact your Morrison & Foerster attorney or any member of the Employee Benefits and Executive Compensation Group:

Mike Frank
Palo Alto
(650) 813-5627
mfrank@mofo.com

Paul Borden
San Francisco
(415) 268-6747
pborden@mofo.com

Yong Yeh
Palo Alto
(650) 813-5672
yyeh@mofo.com

Jessica L. Rice
San Diego
(858) 720-5144
jrice@mofo.com

Yana S. Johnson
San Francisco
(415) 268-7136
yjohnson@mofo.com

Sonja K. Johnson
San Francisco
(415) 268-7694
sjohnson@mofo.com

Ali U. Nardali
Palo Alto
(650) 813-5619
anardali@mofo.com

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