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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9716]

RIN 1545-BI65

Certain Employee Remuneration in Excess of \$1,000,000 under Internal Revenue Code Section 162(m)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the deduction limitation for certain employee remuneration in excess of \$1,000,000 under the Internal Revenue Code (Code).

These regulations affect publicly held corporations.

DATES: Effective date: These regulations are effective on **[INSERT DATE OF**

PUBLICATION IN THE FEDERAL REGISTER].

Applicability date: For dates of applicability, see §1.162-27(j)(2)(vi).

FOR FURTHER INFORMATION CONTACT: Ilya Enkishev at (202) 317-5600 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On June 24, 2011, the Treasury Department and the IRS published a notice of proposed rulemaking (proposed regulations) in the **Federal Register** (76 FR 37034, corrected by 76 FR

55321 on September 7, 2011) under section 162(m) of the Internal Revenue Code (Code). The proposed regulations clarified §1.162-27(e)(2)(vi)(A) by providing that the plan under which an option or stock appreciation right is 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. The proposed regulations also clarified that the general transition rule under §1.162-27(f)(1) for a corporation that becomes a publicly held corporation applies to all compensation other than compensation specifically identified in §1.162-27(f)(3).

The Treasury Department and the IRS received written comments in response to the proposed regulations. All comments were considered and are available for public inspection at <http://www.regulations.gov> or upon request. No public hearing on the proposed regulations was requested or held. After consideration of the comments received, the Treasury Department and the IRS adopt the proposed regulations, with modifications, as final regulations.

Summary of Comments and Explanation of Provisions

1. Maximum number of shares with respect to which options or rights may be granted to each individual employee.

Section 162(m)(1) precludes a deduction under chapter 1 of the Code by any publicly held corporation for compensation paid to any covered employee to the extent that the compensation for the taxable year exceeds \$1,000,000. Section 162(m)(4)(C) provides that the deduction limitation does not apply to qualified performance-based compensation. Section 1.162-27(e)(1) provides that qualified performance-based compensation is compensation that meets all of the requirements of §1.162-27(e)(2) through (e)(5).

The proposed regulations clarified §1.162-27(e)(2)(vi)(A) by providing that the plan under which an option or stock appreciation right is granted must state “the maximum number of shares with respect to which options or rights may be granted during a specified period to any

individual [emphasis added] employee” (per-employee limitation requirement). The existing regulations provide that the per-employee limitation applies to “any employee” during a specified period. The proposed regulations also provided a corresponding clarification of the shareholder approval requirement under §1.162-27(e)(4). Specifically, the proposed regulations clarified §1.162-27(e)(4)(iv) to provide that compensation is not adequately described for purposes of the shareholder approval requirement unless the maximum number of shares on which grants may be made to any individual employee during a specified period and the exercise price of those options is disclosed to the shareholders of the corporation. The proposed regulations provided that the clarifications to §1.162-27(e)(2)(vi)(A) and (e)(4)(iv) apply to amounts that are otherwise deductible for taxable years ending on or after June 24, 2011.

Commenters suggested that these final regulations clarify that under §1.162-27(e)(2)(vi)(A) a plan satisfies the per-employee limitation requirement if the plan specifies the maximum number of shares with respect to which any type of equity-based compensation may be granted to any individual employee during a specified period. Commenters explained that clarification is needed on whether the per-employee limitation may apply to all types of equity-based awards, not merely stock options and stock appreciation rights, which are the two types of equity-based awards described in §1.162-27(e)(2)(vi)(A). In addition, commenters noted that a per-employee limitation on all types of equity-based awards would have the same effect as a per-employee limitation with respect to stock options and stock appreciation rights. In response to these comments, the final regulations modify §1.162-27(e)(2)(vi)(A) to provide that a plan satisfies the per-employee limitation requirement if the plan specifies an aggregate maximum number of shares with respect to which stock options, stock appreciation rights, restricted stock, restricted stock units and other equity-based awards may be granted to any individual employee

during a specified period under a plan approved by shareholders in accordance with §1.162-27(e)(4). This clarification is not intended as a substantive change.

One commenter suggested that the clarification to §1.162-27(e)(2)(vi)(A) apply only to compensation attributable to stock options and stock appreciation rights granted under a plan that was submitted for shareholder approval after August 8, 2011 (that is, forty-five days after the publication of the proposed regulations) and not to grants under plans submitted for shareholder approval before August 9, 2011 (even if the grant was made after that date). Another commenter suggested that the clarification apply only after the first shareholder meeting that occurs at least 12 months after the publication of these final regulations. These commenters reasoned that a transition period is appropriate because a plan providing for an aggregate share limit (but not an explicit per-employee share limitation) arguably satisfies the per-employee limitation requirement under the existing regulations because no individual employee may receive shares in excess of the aggregate limit.

These final regulations do not adopt either of these suggestions. The clarification to §1.162-27(e)(2)(vi)(A) is not a substantive change. The transition rule in §1.162-27(h)(3)(i) of the regulations provides that a plan providing for an aggregate limit, but not a per-employee limit, satisfies §1.162-27(e)(2)(vi)(A) only if the plan was approved by shareholders before December 20, 1993, and only during a limited reliance period specified in §1.162-27(h)(3)(i). Additionally, the legislative history to section 162(m) and the preamble to the 1993 Treasury Regulations (58 FR 66310) under section 162(m) provide for a limit on the maximum number of shares for which options or stock appreciation rights may be granted to individual employees. The preamble to the 1993 Treasury Regulations explains the reason for requiring a per-employee limitation: “Some have questioned why it would be necessary for the regulations to require an

individual [emphasis added] employee limit on the number of the shares for which options or stock appreciation rights may be granted, where shareholder approval of an aggregate limit is obtained for securities law purposes. The regulations follow the legislative history, which suggests that a per-employee limit be required under the terms of the plan.” The preamble further explains that “a limit on the maximum number of shares for which individual employees may receive options or other rights is appropriate because it is consistent with the broader requirement that a performance goal include an objective formula for determining the maximum amount of compensation that an individual employee could receive.” Accordingly, these final regulations provide that the clarification to §1.162-27(e)(2)(vi)(A) applies to compensation attributable to stock options and stock appreciation rights that are granted on or after June 24, 2011 (the date of publication of the proposed regulations).

2. Compensation payable under restricted stock units paid by companies that become publicly held.

In general, §1.162-27(f)(1) provides that when a corporation becomes publicly held, the section 162(m) deduction limitation “does not apply to any remuneration paid pursuant to a compensation plan or agreement that existed during the period in which the corporation was not publicly held.” Pursuant to §1.162-27(f)(2), a corporation may rely on §1.162-27(f)(1) until the earliest of: (i) the expiration of the plan or agreement; (ii) a material modification of the plan or agreement; (iii) the issuance of all employer stock and other compensation that has been allocated under the plan or agreement; or (iv) 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 an initial public offering (IPO) occurs or, in the case of a privately held corporation that becomes publicly held without an IPO, the first calendar year following the calendar year in which the corporation becomes publicly held. Section 1.162-27(f)(3) provides that the relief

provided under §1.162-27(f)(1) applies to any compensation received pursuant to the exercise of a stock option or stock appreciation right, or the substantial vesting of restricted property, granted under a plan or agreement described in §1.162-27(f)(1) if the grant occurs on or before the earliest of the events specified in §1.162-27(f)(2). The proposed regulations clarified that the transition rule in §1.162-27(f)(1) applies to all compensation other than compensation specifically identified in §1.162-27(f)(3). Specifically, the proposed regulations identified compensation payable under a restricted stock unit arrangement (RSU) or a phantom stock arrangement as being ineligible for the transition relief in §1.162-27(f)(3). Therefore, the effect of the proposed regulations is that compensation payable under a RSU is eligible for transition relief only if it is paid, and not merely granted, before the earliest of the events specified in §1.162-27(f)(2).

Commenters suggested that compensation payable under a RSU should qualify for the transition relief in §1.162-27(f)(3) because a RSU is economically similar to restricted stock. These final regulations do not adopt this suggestion. A RSU provides a right to receive an amount of compensation based on the value of stock that is payable in cash, stock, or other property (as defined in §1.83-3(e)) upon the satisfaction of a vesting condition (such as a period of service). Restricted stock, by contrast, is property that has been transferred to the service provider on the date of grant subject to the satisfaction of a specified vesting condition. Restricted stock and RSU's are treated differently under the Code. RSU's generally are treated as nonqualified deferred compensation and may be subject to the rules under section 409A, whereas restricted stock is treated as property and is governed by the rules under section 83. Because compensation attributable to a RSU is in the nature of nonqualified deferred compensation (unlike restricted stock), compensation attributable to a RSU is not sufficiently

similar to restricted property to receive the transition relief provided under §1.162-27(f)(3).

Accordingly, these final regulations adopt the proposed clarification to §1.162-27(f)(3) without change.

The proposed regulations provided that the clarification to §1.162-27(f)(3) would apply on or after the date of publication of the Treasury decision adopting the proposed regulations as final regulations. Commenters suggested that the clarification to §1.162-27(f)(3) should apply to RSU's granted after the publication of final regulations and not merely to remuneration payable under a RSU after the date of publication. These final regulations adopt this suggestion.

Accordingly, these final regulations provide that the clarification to §1.162-27(f)(3) applies to remuneration otherwise deductible under a RSU that is granted on or after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Proposed Effective/Applicability Date

The clarifications to paragraphs (e)(2)(vi)(A), (e)(2)(vii) Example 9, and (e)(4)(iv) of this section apply to compensation attributable to stock options and stock appreciation rights that are granted on or after June 24, 2011. The clarification to §1.162-27(f)(3) applies to any remuneration that is otherwise deductible resulting from a stock option, stock appreciation right, restricted stock (or other property), restricted stock unit, or any other form of equity-based remuneration that is granted on or after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the

Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the proposed regulations preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these final regulations is Ilya Enkishev, Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In § 1.162-27 paragraphs (e)(2)(vi)(A), (e)(2)(vii) Example 9, (e)(4)(iv), and (f)(3) are revised and paragraph (j)(2)(vi) is added to read as follows:

§1.162-27 Certain employee remuneration in excess of \$1,000,000.

* * * * *

(e) ***

(2) ***

(vi) ***

(A) In general. Compensation attributable to a stock option or a stock appreciation right is deemed to satisfy the requirements of this paragraph (e)(2) if the grant or award is made by the compensation committee; 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, under the terms of the option or right, the amount of compensation the employee may receive is based solely on an increase in the value of the stock after the date of the grant or award. A plan may satisfy the requirement to provide a maximum number of shares with respect to which stock options and stock appreciation rights may be granted to any individual employee during a specified period if the plan specifies an aggregate maximum number of shares with respect to which stock options, stock appreciation rights, restricted stock, restricted stock units and other equity-based awards that may be granted to any individual employee during a specified period under a plan approved by shareholders in accordance with §1.162-27(e)(4). If the amount of compensation the employee may receive under the grant or award is not based solely on an increase in the value of the stock after the date of grant or award (for example, in the case of restricted stock, or an option that is granted with an exercise price that is less than the fair market value of the stock as of the date of grant), none of the compensation attributable to the grant or award is qualified performance-based compensation under this paragraph (e)(2)(vi)(A). Whether a stock option grant is based solely on an increase in the value of the stock after the date of grant is determined without regard to any dividend equivalent that may be payable, provided that payment of the dividend equivalent is not made contingent on the exercise of the option. The rule that the compensation attributable to a stock option or stock appreciation right must be based solely on an increase in the value of the stock

after the date of grant or award does not apply if the grant or award is made on account of, or if the vesting or exercisability of the grant or award is contingent on, the attainment of a performance goal that satisfies the requirements of this paragraph (e)(2).

* * * * *

(vii) ***

Example 9. Corporation V establishes a stock option plan for salaried employees. The terms of the stock option plan specify that no individual salaried employee shall receive options for more than 100,000 shares over any 3-year period. The compensation committee grants options for 50,000 shares to each of several salaried employees. The exercise price of each option is equal to or greater than the fair market value of a share of V stock at the time of each grant. Compensation attributable to the exercise of the options satisfies the requirements of paragraph (e)(2)(vi) of this section. If, however, the terms of the options provide that the exercise price is less than fair market value of a share of V stock at the date of grant, no compensation attributable to the exercise of those options satisfies the requirements of this paragraph (e)(2) unless issuance or exercise of the options was contingent upon the attainment of a preestablished performance goal that satisfies this paragraph (e)(2). If, however, the terms of the plan also provide that Corporation V could grant options to purchase no more than 900,000 shares over any 3-year period, but did not provide a limitation on the number of shares that any individual employee could purchase, then no compensation attributable to the exercise of those options satisfies the requirements of paragraph (e)(2)(vi) of this section.

* * * * *

(4) ***

(iv) Description of compensation. Disclosure as to the compensation payable under a performance goal must be specific enough so that shareholders can determine the maximum amount of compensation that could be paid to any individual employee during a specified period. If the terms of the performance goal do not provide for a maximum dollar amount, the disclosure must include the formula under which the compensation would be calculated. Thus, if compensation attributable to the exercise of stock options is equal to the difference between the exercise price and the current value of the stock, then disclosure of the maximum number of shares for which grants may be made to any individual employee during a specified period and

the exercise price of those options (for example, fair market value on date of grant) would satisfy the requirements of this paragraph (e)(4)(iv). In that case, shareholders could calculate the maximum amount of compensation that would be attributable to the exercise of options on the basis of their assumptions as to the future stock price.

* * * * *

(f) ***

(3) Stock-based compensation. Paragraph (f)(1) of this section will apply to any compensation received pursuant to the exercise of a stock option or stock appreciation right, or the substantial vesting of restricted property, granted under a plan or agreement described in paragraph (f)(1) of this section if the grant occurs on or before the earliest of the events specified in paragraph (f)(2) of this section. This paragraph does not apply to any form of stock-based compensation other than the forms listed in the immediately preceding sentence. Thus, for example, compensation payable under a restricted stock unit arrangement or a phantom stock arrangement must be paid, rather than merely granted, on or before the occurrence of the earliest of the events specified in paragraph (f)(2) of this section in order for paragraph (f)(1) of this section to apply.

* * * * *

(j) ***

(2) ***

(vi) The modifications to paragraphs (e)(2)(vi)(A), (e)(2)(vii) Example 9, and (e)(4)(iv) of this section concerning the maximum number of shares with respect to which a stock option or stock appreciation right that may be granted and the amount of compensation that may be paid to any individual employee apply to compensation attributable to stock options and stock

appreciation rights that are granted on or after June 24, 2011. The last two sentences of §1.162-27(f)(3) apply to remuneration that is otherwise deductible resulting from a stock option, stock appreciation right, restricted stock (or other property), restricted stock unit, or any other form of equity-based remuneration that is granted on or after **INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER**.

John Dalrymple,
Deputy Commissioner for Services and Enforcement.

Approved: March 9, 2015.

Mark D. Mazur,
Assistant Secretary of the Treasury (Tax Policy).
[FR Doc. 2015-07386 Filed: 3/30/2015 08:45 am; Publication Date: 3/31/2015]