Technology Companies and Section 162(m) – Compliance Relief for Newly Public Companies

Among the myriad of regulatory challenges that technology companies face once they have completed their initial public offering is compliance with Section 162(m) of the Internal Revenue Code, the provision that, generally, limits the federal income tax deduction that a public company may take for the compensation paid to its senior executives to $1 million per year. While Section 162(m) provides a compliance "transition" period for newly-public companies, advance planning is necessary to minimize any problems in moving to compliance with the provision, if so desired.

This Thoughtful Pay Alert offers strategies for newly-public technology companies to help you successfully navigate the key challenges that may arise in complying with this complex statute.

Section 162(m) – A Brief Overview

Section 162(m) prohibits a public company from taking a federal income tax deduction for any compensation in excess of $1 million paid to its chief executive officer and its three other most highly-compensated executive officers (but specifically excluding its chief financial officer) in any taxable year. Compensation generally includes all remuneration for services performed by a covered executive officer, whether or not the services were performed during the same taxable year in which the compensation is paid.

This $1 million deduction limit does not apply to certain types of compensation, however, including performance-based cash bonuses and full value equity awards, and stock options or stock appreciation rights ("SARs") if such awards satisfy certain conditions involving the grant and terms of the awards. These conditions include a requirement that

Four Items Newly-Public Technology Companies Should Know About Section 162(m)

- Section 162(m) limits the deductibility for any compensation paid by a public company to its chief executive officer and its three other most highly-compensated executive officers (but specifically excluding its chief financial officer) in any taxable year to $1 million. Certain categories of compensation, such as "performance-based compensation," are exempt from this annual deduction limit. To qualify as "performance-based compensation," the related compensation plan must be approved by shareholders (among other things).
- Newly-public companies may take advantage of a specific "transition" rule which enables certain types of equity awards that are granted – or which vest – during a "post-IPO" reliance period of up to three full years to be excluded from the annual deduction limit.
- As of 2012, ISS now conducts a stringent evaluation of first-time equity plan proposals seeking to qualify for the "performance-based compensation" exception even where a company does not propose to add more shares to the plan. Among other things, if the plan contains an "evergreen" feature, this may trigger an "Against" vote recommendation on the equity plan proposal.
- Given the challenges in balancing income tax deductibility with your equity compensation design, newly-public companies and pre-IPO companies should develop a compliance strategy for how they will transition to compliance with Section 162(m) while ensuring that they have adequate shares to grant to their executives and other employees following their IPO.

Technology Companies and Section 162(m) – Compliance Relief for Newly Public Companies (continued)

the material terms of the plan pursuant to which the compensation is paid be approved by shareholders.

Preparing to Comply - Strategies for Newly-Public Companies

Section 162(m) doesn't apply immediately to all of the compensation of a company's covered executives when the company "goes public." Newly-public companies may take advantage of a specific "transition" rule which enables certain types of equity awards that are granted – or which vest – during a "post-IPO" reliance period to be excluded from the annual deduction limit.

This transition rule provides that stock options, SARs, and restricted stock awards granted by a newly-public company pursuant to an equity plan that was in place before the IPO – even if granted following the IPO – may not, for a specified period, be subject to the $1 million deduction limit.

Generally, this relief applies to stock options, SARs, and restricted stock awards granted until the first meeting of the company's shareholders at which directors are to be elected that takes place after the end of the third calendar year following the calendar year in which the company completed its IPO (although the relief may end earlier if the plan is materially amended or in other limited circumstances). For example, the post-IPO reliance period for a technology company that completed its IPO in 2010 will expire at its 2014 annual meeting of shareholders.

The transition rule applies even if the stock options, SARs, or restricted stock awards are exercised or vest after the post-IPO reliance period has ended. Note, however, that, based on 2012 IRS guidance, this blanket protection may not apply to restricted stock unit ("RSU") awards or phantom stock granted during the post-IPO reliance period. Instead, these awards will be exempt from the Section 162(m) deduction limit only if actually settled or paid during the reliance period. Consequently, if your covered executives are being granted RSU awards and/or phantom stock, it is imperative that you consult your tax or other legal counsel to determine the treatment of these awards for purposes of Section 162(m) once you have completed your IPO.

Reliance on the IPO "Transition" Rule

In our experience, at most newly-public technology companies, the post-IPO reliance period will last until the first annual meeting of shareholders at which directors are to be elected that takes place three full years after their IPO. This is typically the case because these companies, prior to their IPO, have put in place an equity plan with a 10-year term and an "evergreen" share reserve feature which provides for annual share increases. Where this evergreen feature is robust (i.e., 4% – 5% per year), typically a company will likely not need to materially amend the plan during the first few years after its IPO.

Preparing for the Expiration of the Post-IPO Reliance Period

Companies that completed their IPOs in 2010 or 2011 are likely to face the end of the Section 162(m) transition relief this year or in 2015. Thus, to qualify for the "performance-based compensation" exception (which will enable them to continue to exclude compensation income recognized in connection with the exercise of stock options and the vesting of other equity awards (other than time-based restricted stock and RSU awards) from the Section 162(m) deduction limit), these companies will need to determine whether (and when) to submit their equity plan for shareholder approval prior to or at the end of the post-IPO reliance period

As of 2012, Institutional Shareholder Services ("ISS") began conducting a more stringent evaluation of first-time equity plan proposals seeking to qualify for the "performance-based compensation" exception, even where a company does not propose to add more shares to the plan. For these proposals, ISS now conducts a full plan analysis, including a review of dilution levels, burn rate practices, and plan terms (for example, whether the plan permits option repricing without shareholder approval and/or contains a "liberal" change in control definition). As a result of this heightened scrutiny, ISS is likely to issue an "Against" vote recommendation if the plan contains an evergreen feature (due to constraints in the ISS dilution test) or maintains the right to reprice options without shareholder approval.

Technology Companies and Section 162(m) – Compliance Relief for Newly Public Companies (continued)

Developing a Section 162(m) Compliance Strategy

Against this backdrop, technology companies that are newly-public or in the process of preparing for their IPO should consider whether to, and how they will, maintain their ability to deduct the compensation income arising from their stock options and other performance-based equity awards following their IPO. While ultimately no action may be needed until the expiration of the post-IPO compliance period draws near, to maintain maximum flexibility – and ensure a smooth integration of the Section 162(m) proscriptions into your executive compensation planning, in our experience it's never too early to begin evaluating the available alternatives. The principal strategies that are available are as follows:

- **Revise the equity plan to comply with ISS policies and seek shareholder approval at the end of the post-IPO reliance period** – the company may determine that the benefits of qualifying for the "performance-based compensation" exception outweigh maintaining the favorable terms of its equity plan (such as the evergreen feature) and that ISS support is necessary to ensure shareholder approval of the plan. In our experience, few companies have used this strategy to date.
- **Do not revise the equity plan but seek shareholder approval at the end of the post-IPO reliance period** – the company may determine that, based an analysis of its shareholder base, it likely will obtain shareholder approval of its equity plan with all or certain favorable terms (for example, maintaining its evergreen feature for a few additional years) even without a favorable ISS vote recommendation. Companies may favor this approach, particularly where their post-IPO shareholder base has not yet developed a broad institutional shareholder presence/influence and current plan terms are viewed as paramount to maintaining a competitive equity program going forward.
- **Do not submit the equity plan for shareholder approval at the end of the post-IPO reliance period** – the company may decide that the favorable terms of its equity plan outweigh the risks associated with attempting to obtain shareholder approval to qualify as "performance-based compensation." This may occur where ISS influence on the company's shareholder base is more significant or where qualification under Section 162(m) is not deemed to be important or necessary to the company's compensation strategy. In this case, the company potentially will be foregoing the deductibility of future stock option and other performance-based equity awards – a result that it may need to justify to its shareholders as part of its future executive compensation disclosures (particularly where the company is profitable and may have material lost deductions).
- **Do not revise the equity plan, but submit the equity plan for shareholder approval prior to the end of the post-IPO reliance period** – the company may decide to submit its equity plan for shareholder approval within the first three years of its IPO when its shareholder base is less subject to ISS' influence and, thus, qualify anew for the "performance-based compensation" exception. This may enable the company to more readily maintain its evergreen feature through the remainder of the post-IPO reliance period.

Recent Technology Company Practices

To better understand where market practices are on these strategies, we examined the SEC filings of 85 technology companies that completed their IPOs from 2010 to 2012. Of the 26 companies in this group that had submitted equity plan proposals to their shareholders for approval prior to the expiration of the post-IPO reliance period, we and learned the following:

- 17% (14 of 85) submitted Section 162(m)-related proposals to their shareholders early – that is, prior to the expiration of the post-IPO reliance period
- The vast majority of these companies maintained the terms of their equity plan "as is" (including "evergreen" and option repricing features) as part of the proposal
- 100% of the Section 162(m)-related proposals were approved by shareholders
- 14% (12 of 85) submitted other material amendments (typically share increases) to their shareholders for approval prior to the expiration of the post-IPO reliance period and, in many cases, bundled re-approval of the Section 162(m)-related provisions into the proposal.

Technology Companies and Section 162(m) – Compliance Relief for Newly Public Companies (continued)

Interested in Other Section 162(m)-Related Issues?

For a discussion of the recent litigation issues that have arisen under Section 162(m) and ways to minimize these risks, see our Thoughtful Pay Alert, Technology Companies and Section 162(m): Minimizing Litigation Risks »

Need Assistance?

Compensia has extensive experience in helping pre-IPO and newly-public companies understand and prepare for their corporate governance, reporting, and other obligations as a public company, including strategies for complying with Section 162(m) of the Internal Revenue Code. If you have any questions on the subjects addressed in this Thoughtful Pay Alert or would like assistance in assessing their likely impact on your executive compensation plans, please feel free to contact us. ■

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