

# Avoiding the \$1 Million Tax Trap – New Section 162(m) Regulations Affect Use of RSUs by IPO-Companies

**O**n March 31, 2015, the Internal Revenue Service adopted final regulations under Section 162(m) of the Internal Revenue Code with important implications for the use of restricted stock unit (“RSU”) awards following a company’s initial public offering.

This Thoughtful Pay Alert summarizes the requirements of these final regulations as they apply to newly-public companies which either use or are considering using RSU awards as part of their long-term incentive compensation program.

## 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. Certain categories of compensation, such as “performance-based compensation,” are exempt from this annual deduction limit.

Section 162(m) doesn’t apply immediately to all of its covered executives’ compensation when a company “goes public.” Newly-public companies may take advantage of a specific “transition” rule which provides that the compensation attributable to stock options, SARs, and restricted stock awards granted pursuant to an equity plan that was in place

before the IPO – even if made following the IPO – may not, for a certain period, be subject to the 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). Most significantly, this 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.

## Treatment of RSUs Following an IPO

Previously, there was a question whether this blanket protection applied to restricted stock unit (“RSU”) awards and phantom stock arrangements granted during the post-IPO reliance period. The final regulations confirm the IRS’ position that it does not. In particular, the final regulations provide that RSU awards (and phantom stock arrangements) granted on or after April 1, 2015 will be exempt from the Section 162(m) deduction limit only if and to the extent they vest and are paid before the end of the post-IPO reliance period.

### Sample Timeline under Final Regulations for RSUs



Note that actual restricted stock awards – as opposed to RSU awards – continue to be exempt from the Section 162(m) deduction limit if granted during the post-IPO reliance period, regardless of when the awards actually vest.

## Avoiding the \$1 Million Tax Trap – New Section 162(m) Regulations Affect Use of RSUs by IPO-Companies (continued)

Note that this position is prospective only (that is, it only applies to RSU awards granted on or after April 1, 2015). RSU awards granted prior to April 1, 2015 and during an existing post-IPO reliance period will continue to be exempt from the Section 162(m) deduction limit regardless of when they vest and are paid.

Note also that this position only applies to RSU awards, and not to restricted stock awards ("RSAs"). Restricted stock awards granted by a newly-public company remain eligible for the full exemption from the deduction limit even if they vest after the post-IPO reliance period.

### Use of Restricted Stock and RSU Awards Merits Careful Consideration

We recommend that late-stage privately-held companies and newly-public companies consider the potential impact of these final regulations when developing their annual equity award strategies. While companies with significant loss carry-forwards will not be affected by this issue until they begin generating income, companies fac-

ing an annual tax liability will clearly be affected by their choice of equity vehicles.

During the post-IPO reliance period, companies may decide that it is more expedient to grant restricted stock awards, rather than RSU awards, to current or potential executive officers to maximize the potential deductibility of this compensation. We note that several companies have already taken such action in response to the final regulations, while others are now in the process of doing so.

### Need Assistance?

Compensia has broad 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 and the pros and cons associated with both restricted stock and RSU awards. 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 compensation programs, please contact your Compensia consultant. ■

## About Compensia

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