

Section 162(m)(4)(C)—Dividends and Dividend Equivalents on Restricted Stock and Restricted Stock Units

26 CFR 1.162-27(e)

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ISSUE

Whether dividends and dividend equivalents relating to restricted stock and restricted stock units (RSUs) that are performance-based compensation under § 162(m)(4)(C) of the Internal Revenue Code must separately satisfy the requirements under § 162(m)(4)(C) to be treated as performance-based compensation.

FACTS

Corporation X and Corporation Y are publicly held corporations within the meaning of § 162(m)(2). Both corporations maintain plans under which participating employees may be granted restricted common stock of the respective corporation or RSUs based upon the common stock of the respective corporation. The restricted stock and RSUs granted under the plans of Corporations X and Y vest upon the attainment of certain preestablished, objective performance goals and otherwise meet the requirements of § 1.162-27(e). Accordingly, the compensation received due to the vesting of the restricted stock and the vesting and payment of the RSUs is qualified performance-based compensation that is excluded from the applicable employee remuneration to which the deduction limitation under § 162(m) applies.

Situation 1. Corporation X's plan provides that dividends and dividend equivalents otherwise payable to an employee during the period from grant through vesting with respect to performance-based restricted stock and RSU awards granted to the employee are accumulated and become vested and payable only if the related performance goals with respect to the restricted stock and RSUs are satisfied. All other requirements of § 1.162-27(e) are met with respect to the grant of rights to dividends and dividend equivalents.

Situation 2. Corporation Y's plan provides for payment to an employee during the period from grant to vesting of dividends and dividend equivalents with respect to performance-based restricted stock and RSU awards granted to the employee at the same time dividends are paid on common stock of Corporation Y regardless of whether

the performance goals established with respect to the restricted stock and RSUs are satisfied.

LAW

Section 162(a)(1) allows as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered.

Section 162(m)(1) provides that in the case of any publicly held corporation, no deduction is allowed for applicable employee remuneration with respect to any covered employee to the extent that the amount of the remuneration for the taxable year exceeds \$1,000,000.

Section 162(m)(3) provides that the term “covered employee” means any employee of the taxpayer if (i) as of the close of the taxable year, such employee is the chief executive officer of the taxpayer or is an individual acting in such a capacity, or (ii) the total compensation of such employee for the taxable year is required to be reported to shareholders under the Securities Exchange Act of 1934 (Exchange Act) by reason of such employee being among the four highest compensated officers for the taxable year (other than the chief executive officer). See Notice 2007-49, 2007-1 C.B. 1429 (providing changes to the application of this provision based on changes in the Exchange Act compensation disclosure rules).

Section 162(m)(4)(A) defines “applicable employee remuneration,” with respect to any covered employee for any taxable year, generally as the aggregate amount allowable as a deduction for the taxable year (determined without regard to § 162(m)) for remuneration for services performed by the employee (whether or not during the taxable year).

Section 162(m)(4)(C) provides that applicable employee remuneration does not include any remuneration payable solely on account of the attainment of one or more performance goals, but only if (i) the performance goals are determined by a compensation committee of the board of directors of the taxpayer which is comprised solely of two or more outside directors, (ii) the material terms under which the remuneration is to be paid, including the performance goals, are disclosed to shareholders and approved by a majority of the vote in a separate shareholder vote before payment of such remuneration, and (iii) before any payment of such remuneration, the compensation committee certifies that the performance goals and other material terms were in fact satisfied. Rules with respect to these requirements are set forth in §§ 1.162-27(e)(2) through (e)(5).

Section 1.162-27(e)(2)(i) provides that qualified performance-based compensation must be paid solely on account of the attainment of one or more

preestablished, objective performance goals. Section 1.162-27-(e)(2)(ii) provides that a preestablished performance goal must state, in terms of an objective formula or standard, the method for computing the amount of compensation payable to the employee if the goal is attained.

Section 1.162-27(e)(2)(iv) provides that the determination of whether compensation satisfies the requirements of § 1.162-27(e)(2) generally is made on a grant-by-grant basis. Section 1.162-27(e)(2)(iv) further provides that, except as provided in § 1.162-27(e)(2)(vi) (relating to stock options and stock appreciation rights), whether a grant of restricted stock or other stock-based compensation satisfies the performance goal requirements is determined without regard to whether dividends, dividend equivalents, or other similar distributions with respect to stock, on such stock-based compensation are payable prior to the attainment of the performance goal. Dividends, dividend equivalents, or other similar distributions with respect to stock that are treated as separate grants under § 1.162-27(e)(2)(iv) are not performance-based compensation unless they separately satisfy the performance goal requirements. Such performance goals may or may not be the same as the performance goals for the related stock-based compensation.

ANALYSIS

Under § 1.162-27(e)(2)(iv), the dividends and dividend equivalents under Corporation X's plan and under Corporation Y's plan are grants of compensation that are separate and apart from the related restricted stock and RSU grants. Therefore, the grants of the dividends and dividend equivalents must separately satisfy the requirements of § 1.162-27(e) to be qualified performance-based compensation.

Situation 1. Under Corporation X's plan, participants' rights to restricted stock and RSUs are subject to performance goals that meet the requirements of § 1.162-27(e) and are excluded from applicable remuneration for purposes of applying the § 162(m)(1) deduction limitation. Under the same plan, participants' rights to dividends and dividend equivalents vest and become payable only if the same performance goals that apply to the related grants of restricted stock and RSUs are satisfied. Therefore, dividends and dividend equivalents under X's plan are also excluded from applicable remuneration for purposes of applying the § 162(m)(1) deduction limitation.

Situation 2. The dividends and dividend equivalents under Corporation Y's plan fail to satisfy the requirements under § 162(m)(4)(C) and § 1.162-27(e) because the rights to these amounts do not vest and become payable solely on account of the attainment of preestablished performance goals. Thus, these amounts are not qualified performance-based compensation, regardless of whether the performance goals are met with respect to the related restricted stock and RSUs.

HOLDINGS

Situation 1. With respect to Corporation X, dividends and dividend equivalents paid under X's plan are qualified-performance based compensation and therefore are excluded from applicable employee remuneration for purposes of applying the \$1,000,000 limitation on deductibility under § 162(m)(1).

Situation 2. With respect to Corporation Y, dividends and dividend equivalents paid under Y's plan are not qualified-performance based compensation and therefore are included in applicable employee remuneration for purposes of applying the \$1,000,000 limitation on deductibility under § 162(m)(1).

DRAFTING INFORMATION

This revenue ruling was prepared by Dara Alderman of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt & Government Entities). For further information regarding this revenue ruling, contact Ms. Alderman at (202) 622-6030 (not a toll-free call).