

Executive Compensation and Benefits Alert

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IRS Clarifies Treatment of Dividends and Dividend Equivalents Under Section 162(m)

On June 25, 2012, the Internal Revenue Service issued Revenue Ruling 2012-19, clarifying that dividends and dividend equivalents relating to restricted stock and restricted stock units (RSUs) intended to qualify as performance-based compensation must themselves separately satisfy the requirements applicable to performance-based compensation under Section 162(m) of the Internal Revenue Code (Section 162(m)). These performance goals may, but need not be, the same performance goals applicable to the related stock-based award.

Section 162(m) generally does not permit a publicly held corporation to deduct, for federal income tax purposes, compensation in excess of \$1 million per year paid to a "covered employee" (generally the officers named in the corporation's proxy other than the chief financial officer). However, there are certain exceptions to this deduction limit, including an exemption for "qualified performance-based compensation," which is compensation that meets a number of requirements set forth in the regulations under Section 162(m), including it be payable solely on account of attainment of pre-established performance goals.

The regulations under Section 162(m) provide that a grant of restricted stock or RSUs does not fail to satisfy the performance goal requirements solely because the related dividends or dividend equivalents are payable prior to the attainment of the performance goal applicable to the underlying restricted stock or RSUs. The revenue ruling clarifies, however, that because the related dividends or dividend equivalents are treated as separate grants under the Section 162(m) regulations, they must separately satisfy performance goal requirements to be considered qualified performance-based compensation.

To illustrate these rules, the revenue ruling presents two situations:

- (1) Dividends and dividend equivalents relating to performance-based restricted stock and RSU awards are accumulated during the vesting period of the related restricted stock or RSU and become payable, only if the related restricted stock and RSUs vest. Under this scenario, the dividends and dividend equivalents satisfy the performance goal requirements because the applicable performance goals apply to both the restricted stock and RSU awards, as well as to the dividends and dividend equivalents.
- (2) Dividends and dividend equivalents relating to performance-based restricted stock and RSU awards are paid on a current basis without regard to whether the performance goals established with respect to the restricted stock and

RSUs are satisfied. Under this scenario, the dividends and dividend equivalents do not satisfy the performance goal requirements and therefore do not qualify as performance-based compensation.

Although the revenue ruling position is not surprising, it is a useful reminder that companies need to be mindful that current payment of dividends or dividend equivalents relating to performance-based restricted stock and RSUs, may not be deductible.

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