

## Ensuring Deductions for Performance-Based Compensation in Excess of \$1 Million

### PRACTICE AREAS

Executive Compensation and  
Fringe Benefits

Qualified Retirement Plans

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*The final Regulations implementing the Section 162(m) limitation amplify the application of the general rule with respect to publicly held corporations, covered employees, and affected compensation. Most important are the provisions governing the exception for performance-based compensation-how it is established by outside directors and how to maintain the necessary elements such as performance goals and shareholder approval. A special exemption applies for privately held companies that go public, and there are transition rules that will affect many publicly held corporations with pre-existing bonus plans.*

Final Regulations interpreting Section 162(m) , the "\$1 million compensation cap," were issued by the Service on 12/19/95 ( TD 8650 ), having been preceded by two sets of Proposed Regulations and a couple of IRS pronouncements.<sup>1</sup> That section generally denies a publicly held corporation a deduction for compensation paid to a covered employee to the extent the compensation exceeds \$1 million. The major exception to application of the limitation is "performance-based compensation." Special rules deal specifically with written binding contracts in effect on

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2/17/93, transition rules, and other delayed effective date rules.

**PUBLICLY HELD CORPORATION**

A "publicly held corporation," under Section 162(m) , is "any corporation issuing any class of common equity securities required to be registered under section 12 of the Securities Exchange Act of 1934" (the "1934 Act").<sup>2</sup> SEC regulations define common equity as "any class of common stock or an equivalent interest, including but not limited to a unit of beneficial interest in a trust or a limited partnership interest."<sup>3</sup> A corporation is not publicly held if the registration of its equity securities is voluntary.<sup>4</sup> Under the Regulations, the status of a corporation as publicly held is determined based solely on whether, as of the last day of its tax year, the corporation is subject to the reporting obligations of the 1934 Act.<sup>5</sup>

Securities other than "exempt securities" are required to be registered under section 12 of the 1934 Act if they are either:

- (1.) Securities traded on a "national securities exchange" ("section 12(a) registration").
- (2.) Equity securities that are not traded on a national securities exchange ("over the counter" traded shares) and that satisfy the asset and shareholder tests of the 1934 Act ("section 12(g) registration").

Under section 12(g)(3), the SEC may "exempt from this subsection" the securities of any foreign issuer. The SEC, for instance, has used its authority to exempt foreign private issuers of American Depositary Receipts ("ADRs") from the section 12(g) registration requirements.<sup>6</sup> The exemption applies, however, solely for purposes of these registration requirements-it does not cover ADRs subject to section 12(a) registration. The classification of other "exempt securities" under section 12 of the 1934 Act is narrow, and does not include ADRs.<sup>7</sup> Thus, ADRs traded on the New York Stock Exchange are subject to the section 12(a) registration requirements.

Under this definition, ADRs of a foreign corporation traded on the New York Stock Exchange, for example, would be considered common equity stock. The foreign corporation, accordingly, would be a publicly held corporation for purposes of Section 162(m) . As discussed below, however, it generally would not have any "covered employees" and thus would not be subject to the deduction limitation of Section 162(m).

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**Affiliated groups.** A publicly held corporation includes an affiliated group of corporations as defined in Section 1504 (determined without regard to Section 1504(b) ). An affiliated group does not, however, include any subsidiary that is itself a publicly held corporation. Such a publicly held subsidiary, and its subsidiaries (if any), are separately subject to Section 162(m) .

If a covered employee is compensated in one tax year by more than one member of an affiliated group, the employee's compensation paid by all members of the group is aggregated. Any amount disallowed as a deduction must be prorated among the payor corporations in proportion to the compensation paid by each.<sup>8</sup>

**COVERED EMPLOYEE**

Under Section 162(m)(3) , a "covered employee" is any employee of the taxpayer who is either:

- (1.) The taxpayer's CEO (or acts in the capacity of CEO) as of the close of the tax year.
- (2.) Among the four highest compensated officers for the corporation's tax year (other than the CEO), as of the end of that year, i.e., has total compensation for the year that is required to be reported to shareholders under the 1934 Act.<sup>9</sup>

To what extent does Section 162(m) apply to the U.S. subsidiaries of foreign corporations, particularly those that have ADRs traded on the New York Stock Exchange? Are any of the officers of the U.S. subsidiary "covered employees"?

Section 162(m)(3)(B) applies only to compensation required to be "reported to shareholders" with respect to the four top-paid officers. SEC Regulation S-K requires certain reporting with respect to the compensation of the corporation's CEO and the corporation's four top-paid executives (the "S-K top-four rules").<sup>10</sup> To the extent required by SEC regulations, the S-K top-four rules apply to (1) registration statements filed under section 12 of the 1934 Act; (2) annual reports required under section 13 of that Act; (3) interim reports required under section 15(d) of that Act (with regard to change-of-fiscal-year events); and (4) reports to shareholders in connection with proxy solicitations required under section 14 of the 1934 Act.<sup>11</sup>

It is not entirely clear whether the reports required to be filed with the SEC under sections 12, 13 and 15(d) constitute "reporting to shareholders" under Section 162(m) . In addition, the shareholder reporting required under section 14 does not include the S-K top-four rules.<sup>12</sup> While not crystal clear, it appears that these reporting requirements as applied to the officers of a U.S. subsidiary of a foreign

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corporation do not include the S-K top-four rules.

Under Section 162(m)(3)(A) , it appears that a CEO is subject to the \$1 million cap without regard to whether compensation is subject to the SEC reporting rules. The Regulations arguably could be read to narrow the statute, so that even the CEO is not subject to Section 162(m) unless the SEC compensation reporting rules apply.<sup>13</sup>

**COMPENSATION**

Under Reg. 1.162-27(c)(3) , compensation is the aggregate amount deductible under chapter 1 of the Code for the tax year (determined without regard to Section 162(m) ) for remuneration for services performed by a covered employee, whether or not the services were performed during that year. Compensation does not include:

- (1.) Remuneration covered in Sections 3121(a)(5)(A) through (D) (essentially, contributions to and payments from qualified plans).
- (2.) Benefits provided to or on behalf of an employee if, when the benefit is provided, it is reasonable to believe that the employee will be able to exclude it from gross income.
- (3.) Salary reduction contributions described in Section 3121(v)(1).

The Section 162(m) concept of compensation is broad, effectively covering all of the taxable compensation income received by an individual from his employer. For example, income from a nonexcludable fringe benefit such as a discriminatory medical benefit plan under Section 105(h) will be subject to the Section 162(m) deduction limit.

**Commissions.** Section 162(m) does not apply to any compensation paid on a commission basis, i.e., if the facts and circumstances show that it is paid solely on account of income generated directly by the separate performance of the individual to whom the compensation is paid ( Reg. 1.162-27(d) ). The mere use of support services, such as secretarial or research services, does not affect the determination of whether the compensation is attributable directly to the individual. If, however, compensation is paid on account of broader performance standards, such as income produced by a business unit of the corporation, the compensation does not qualify for this exception.

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**PERFORMANCE-BASED COMPENSATION**

Under Section 162(m)(4)(C) , qualified performance-based compensation that is not subject to the deduction limitation is any remuneration payable solely on the account of the attainment of one or more performance goals, if:

- (1.) The goals are determined by a compensation committee of the taxpayer's board of directors made up solely of two or more outside directors.
- (2.) The material terms under which the remuneration is to be paid, including the performance goals, are disclosed to shareholders and approved by a majority in a separate shareholder vote before payment. 14
- (3.) Before payment is made, the committee certifies that the performance goals and any other material terms were satisfied.

**COMPENSATION COMMITTEE**

Reg. 1.162-27(c)(4) provides that "compensation committee" means the directors' committee (including any subcommittee) that has the authority to establish and administer performance goals, and to certify that those goals are attained. Authority will not be lacking merely because the goals are ratified by the full board of directors (or, if applicable, by any other committee of the board).

**Outside directors.** Under Reg. 1.162-27(e)(3) , the compensation committee must comprise solely two or more outside directors. Because of the critical nature of this requirement, a corporation concerned with Section 162(m) should permanently maintain adequate written records demonstrating compliance with the rules. Normal record retention rules should not be followed because it could be many years after an award is made before it becomes necessary to prove to an IRS agent that all of the outside directors on the compensation committee met the regulatory requirements.

An outside director:

- (1.) Is not a current employee 15 of the publicly held corporation.
- (2.) Is not a former employee of the publicly held corporation who receives compensation for prior services (other than benefits under a qualified retirement plan) during the tax year.
- (3.) Has not been an officer of the publicly held corporation.
- (4.) Does not receive remuneration (including any payment in exchange for goods or services)

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from the publicly held corporation, either directly or indirectly, in any capacity other than as a director.

The Regulations illustrate a director's receipt of direct or indirect remuneration as follows:

- (1.) It is paid, directly or indirectly, to the director personally or to an entity<sup>16</sup> in which the director has a beneficial ownership interest of greater than 50%. The rules relating to what is indirect remuneration can be complex and bear close attention. <sup>17</sup>
- (2.) It was paid (other than de minimis remuneration) by the publicly held corporation in its preceding tax year to an entity in which the director has a beneficial ownership interest of at least 5% but not more than 50%.
- (3.) It was paid (other than de minimis remuneration) by the publicly held corporation in its preceding tax year to an entity by which the director is employed or self-employed other than as a director. <sup>18</sup>

**De minimis payments.** Remuneration that was paid by the publicly held corporation in its preceding tax year to an entity is de minimis if payments to the entity did not exceed 5% of the gross revenue of the entity for its tax year ending with or within that preceding tax year of the publicly held corporation ( Reg. 1.162-27(e)(3)(iii) ). Remuneration in excess of \$60,000 is not de minimis, however, if the remuneration is paid to an entity described in 2, above, or is paid for personal services to an entity described in 3, above.

Remuneration from a publicly held corporation is paid for personal services if two tests are met. First, it is paid to an entity for personal or professional services, consisting of legal, accounting, investment banking, and management consulting services<sup>19</sup> (and other similar services that may be specified by the IRS in Revenue Rulings, Notices, or other published guidance), performed for the publicly held corporation, and is not for services that are incidental to the purchase of goods or to the purchase of services that are not personal services. Second, the director performs significant services (whether or not as an employee) for the corporation, division, or similar organization (within the entity) that actually provides the services described above to the publicly held corporation, or more than 50% of the entity's gross revenues (for the entity's preceding tax year) are derived from that corporation, subsidiary, or similar organization.

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**PERFORMANCE GOALS**

Many of the more difficult issues under Section 162(m) relate to the performance goal requirement. Reg. 1.162-27(e)(2)(i) , in language identical to the 1993 Proposed Regulations, states that qualified performance-based compensation must be paid solely on account of the attainment of one or more pre-established, objective performance goals.

**Pre-established goal.** A performance goal is pre-established if it is put in writing by the compensation committee within 90 days<sup>20</sup> after the commencement of the period of service to which the performance goal relates, provided that the outcome is substantially uncertain at the time the compensation committee actually establishes the goal. A goal cannot be pre-established if it is set after 25% of the period of service (as scheduled in good faith at the time the goal is established) has elapsed.

What does it mean that the outcome of the performance goal has to be "substantially uncertain" when the compensation committee establishes the goal? What kind of hindsight can an IRS agent use to challenge a performance goal that the agent believes was not substantially uncertain at the time the goal was established? For example, could an agent challenge an earnings-based goal that permits specified adjustments to earnings to be taken into account in the computation of the earnings? Unfortunately, because of the loose language in the Regulations, the answer to this latter question would appear to be yes, particularly if the adjustment makes it more likely that the earnings goal will be met. For instance, excluding all extraordinary losses from the computation of net earnings might be sufficient to lead an agent to question the "substantial uncertainty" status of the goal.<sup>21</sup> Such a challenge would, however, seem to be wrong.

The Service has provided limited guidance on the meaning of "substantially uncertain." According to the examples in the Regulations, basing a bonus on an increase in sales or net profits is permissible while basing a bonus on total sales is not.<sup>22</sup> The substantially uncertain standard would be violated if the compensation was established when attainment of the standard is a mere formality.<sup>23</sup>

The phrase "services to which the performance goal relates" is somewhat ambiguous. For instance, how does it apply to a covered employee who is hired or promoted into the class of eligible participants after the performance period has commenced? The answer is not clear, although it appears that, with respect to such a covered employee, the performance goal will fail to be "pre-established."<sup>24</sup>

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Another potential concern relates to earnings-based goals that are based on average earnings of the corporation as compared with average earnings for a peer group (variously referred to as "peer-review" plans, "external validation" plans, or "relative peer measurement" plans).<sup>25</sup> If the earnings included in the goal relate in part to earnings in years prior to the actual performance year or years, does such a methodology violate the substantially uncertain test or any other aspect of the regulatory requirements? The better argument would appear to be that the use of such averages is permissible.

**Objective compensation formula.** A performance goal is objective if a third party having knowledge of the relevant facts could (1) determine whether the goal is met and (2) mathematically calculate the actual amount payable. The formula or standard must specify the individual employees or class of employees to which it applies.<sup>26</sup>

Performance goals can be based on one or more business criteria that apply to the individual, a business unit (e.g., a division or line of business), or the corporation as a whole. Such business criteria could include, for example, stock price, market share, sales, earnings per share, return on equity, or costs. A performance goal need not, however, be based on an increase or positive result under a business criterion—it could include, for example, maintaining the status quo or limiting economic losses (measured, in each case, by reference to a specific business criterion). A performance goal does not include the mere continued employment of the covered employee. Thus, a vesting provision based solely on continued employment would not be a performance goal.

An award may be performance-based even if an executive who retires before the end of the goal period (e.g., in the second year of a three-year incentive bonus program) is entitled to receive compensation if the goal is later satisfied. One day of service by the executive may be enough to allow an award based on multiple years of profits or stock appreciation to qualify as performance based.

**Discretion.** The terms of an objective formula or standard must preclude discretion to increase the compensation payable that otherwise would be due on attainment of the goal. Negative discretion is, however, permissible.<sup>27</sup> Consequently, a performance goal is not discretionary for purposes of Section 162(m) -i.e., it does not violate the objectivity requirement—merely because the compensation committee reduces or eliminates the compensation or other economic benefit that was due on attainment of the goal.

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Understanding this aspect of the Regulations is critical. If a corporation is willing to set an upside limit to performance-based compensation and is willing to tell its shareholders that compensation up to that limit may be paid if the goals are met, any compensation below that limit may be paid without losing any deduction because of Section 162(m). Proper planning will give compensation committees almost limitless discretion to set the compensation levels of key executives. Many corporations have adopted this approach.<sup>28</sup>

There nevertheless are some limits to the discretion ("prohibited or impermissible discretion") that may be retained by a compensation committee in setting pay levels. For example, the exercise of negative discretion with respect to one employee cannot result in an increase in the amount payable to another employee.<sup>29</sup> Thus, for instance, if the amount payable to each employee in a bonus pool is stated in terms of a percentage of the pool, the sum of these individual percentages of the pool cannot exceed 100%. If the terms of an objective formula or standard fail to preclude discretion to increase the compensation merely because the amount to be paid on attainment of the performance goal is based, in whole or in part, on a percentage of salary or base pay and the dollar amount of the salary or base pay is not fixed when the performance goal is established, the objective formula or standard will not be prohibited discretion if the maximum dollar amount to be paid is fixed at that time.<sup>30</sup>

One aspect of pre- Section 162(m) performance-based compensation that has had to be changed by many corporations concerns the use of a compensation formula based on achieving budgeted earnings or return on equity or return on assets.<sup>31</sup> Many such plans gave the compensation committee the power to adjust the corporation's earnings because of "unusual or nonrecurring events" that affected earnings during the year. Retention of such provisions could violate the no-discretion rule of the Regulations. Any adjustments that the compensation committee may want to make to the earnings standard should be specified in the plan.<sup>32</sup> It should, for instance, be permissible for a plan to specifically exclude from the computation of earnings "extraordinary items" as determined under generally accepted accounting principles (GAAP), since the use of professional judgment in applying GAAP should not be viewed as the equivalent of discretion.

Changing the time of payment of compensation will not necessarily affect the status of the compensation as performance-based as long as the payment is not made before the attainment of the performance goal.<sup>33</sup> A change that accelerates the payment to an earlier date after the attainment of the goal will be treated as an increase in compensation unless the amount paid is discounted to reasonably reflect the

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time value of money. If payment is deferred, any excess over what was originally owed to the employee will not be treated as an increase in the amount of compensation if the additional amount is based on either a reasonable rate of interest<sup>34</sup> or on one or more predetermined actual investments (even if assets associated with the amount originally owed are not invested therein) such that the amount payable by the employer at the later date will be based on the actual rate of return of a specific investment (including any decrease as well as any increase in the value of an investment).<sup>35</sup>

If compensation is payable in the form of property, a change in the timing of the transfer of that property after the attainment of the goal will not be an increase in compensation for purposes of the Regulations. Thus, for example, if the terms of a stock grant provide for stock to be transferred after the attainment of a performance goal and the transfer of the stock also is subject to a vesting schedule, a change in the vesting schedule that either accelerates or defers the transfer of stock will not be an increase in the compensation payable under the performance goal.

Under Reg. 1.162-27(e)(2)(iii)(C), compensation attributable to a stock option, stock appreciation right, or any stock-based compensation does not fail to be performance-based to the extent that a change in the grant or award is made to reflect changes in corporate capitalization. In a noteworthy lack of guidance, the Regulations do not sanction adjustments in an award to reflect changes in corporate capitalization when performance-based compensation is other than stock based.

Example: Corporations X and Y are both publicly traded and maintain bonus plans for covered employees that use earnings-per-share targets. As a result of the merger of X and Y, the earnings-per-share targets should be adjusted. Can an equitable adjustment be made without destroying the Section 162(m) exception previously enjoyed by this performance plan? If the adjustment would pass muster under rules similar to those set forth in Section 424(a) (governing adjustments to statutory stock options to account for corporate recapitalization), there should not be a material change of the performance goals that would require new shareholder approval.<sup>36</sup>

**Grant-by-grant determination.** In general, whether compensation meets the performance goal requirement is determined on a grant-by-grant basis. For example, whether compensation attributable to a stock option grant satisfies this requirement generally is determined without regard to the terms of any other option grant or other grant of compensation to the same or another employee. Thus, no award under a plan will be disqualified as performance based merely because nonqualifying awards under the same plan may be, or are, made.<sup>37</sup>

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Compensation contingent on attainment of performance goal. Compensation does not satisfy the performance goal requirement if the facts and circumstances indicate that the employee would receive all or part of the compensation regardless of whether the performance goal is attained. This determination is made taking into account all plans, arrangements, and agreements that provide for compensation to the employee. According to the Service, this aggregation requirement is a "limited exception" to the grant-by-grant test described above and applies only for the purpose of determining whether the employee would receive, regardless of whether the performance goal is attained, compensation that purports to be performance-based. 38 Thus, for example, Reg. 1.162-27(e)(2)(v) provides that if payment under a nonperformance-based compensation arrangement is contingent on the failure to attain a performance goal under a second, otherwise performance-based arrangement, neither arrangement meets the test. If taken to its logical conclusion, this aggregation requirement gives the Service a powerful argument where a taxpayer has been paid some nonperformance-based compensation close in time to the nonpayment of performance-based compensation.

In the Preamble to the 1993 Proposed Regulations, IRS explained why it concluded that it would not permit bifurcation of discount stock options into performance-based and nonperformance-based compensation: "... for the exception for performance-based compensation to be meaningful, the determination of whether compensation meets those requirements must be made with regard to all of the compensation that is payable to an employee under a single transaction or upon the occurrence of a single set of events.... Moreover, not bifurcating discount options is consistent with the position taken for all plans, including stock-based plans, which treats compensation as not satisfying the requirements of qualified performance-based compensation where the employee would receive all or part of the compensation regardless of whether the performance goal is attained. It is not intended, however, that this rule be read so broadly as to preclude compensation from being performance-based merely because the employee also may receive other non-performance-based compensation that is not related to the same transaction or set of events, such as salary." 39 Thus, if the payment of compensation under a grant or award is only nominally or partially contingent on attaining a performance goal, none of the compensation payable under the grant or award will be performance based.<sup>40</sup>

Compensation does not fail to be qualified performance-based compensation merely because the plan allows it to be payable on death, disability, or change of ownership or control, although compensation actually paid on account of those events prior to the attainment of the goal would not satisfy the performance-goal requirement. If, however, the employee ceases to be employed by the corporation

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prior to the last day of the deduction year (whether as a result of death, disability, change of control, or otherwise), the compensation will nonetheless be exempt from the \$1 million deduction limit on the ground that the executive is not a covered employee.

**Options and SARs.** Compensation attributable to a stock option or a stock appreciation right (SAR) is deemed to satisfy the performance-goal requirement of the Regulations if:

- (1.) The grant or award is made by the compensation committee.
- (2.) 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 employee.  
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- (3.) Under the terms of the option or right, the compensation the employee could receive is based solely on an increase in the value of the stock after the date of the grant or award.

If the compensation the employee will 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 (e.g., restricted stock, or an option that is granted with an exercise price that is less than the FMV of the stock as of the date of grant), none of the compensation attributable to the grant or award is qualified performance-based compensation.<sup>42</sup> Thus, an option or SAR that is in-the-money by even a small amount at grant will not meet the performance-goal requirement, even as to post-grant appreciation (unless the option is subject to vesting or restrictions on exercise based on a separate performance goal or SAR). While the Regulations give no guidance on how to determine the FMV of stock on the grant date, it is reasonable to assume that the rules applicable to statutory stock options will apply.<sup>43</sup>

If a company cancels or reprices a stock award, the shares covered by the original award (as well as any shares covered by a new or modified award) continue to count against the covered employee's share limit.<sup>44</sup>

**Dividend equivalents.** The Regulations distinguish between contingent and noncontingent dividend equivalents—only the latter do not infect the related option. Thus, Reg. 1.162-27(e)(2)(vi)(A) provides that 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 dividends, dividend equivalents, or other similar distributions that may be payable, provided that payment of any such distribution is not contingent on the exercise of the option. If, however, the payment of the dividend equivalent is conditioned on the

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employee exercising the option, the Preamble to TD 8650 indicates that IRS believes that the dividend effectively reduces the exercise price of the option, thereby causing the option to be nonperformance-based at exercise.

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 the Regulations. In other words, restricted stock awards, discount stock options, and other stock-based awards can qualify as performance-based compensation on their own.

**Restricted stock.** The Conference Report provides that a grant of restricted stock does not qualify for the performance-based compensation exception (where the stock is worth more than the executive pays for it, if anything) because the executive can profit even if the stock value stays the same or declines after grant, unless "the grant or vesting of the restricted stock is based upon the attainment of a performance goal."<sup>45</sup>

Where restricted stock is subject to a vesting restriction that allows the executive to retain the stock only if one or more objective performance goals are met, a Section 83(b) election by the covered employee usually will result in the corporation's deduction occurring before the performance goals are met and before the compensation committee can certify that they are met. Does this mean that all Section 83(b) elections automatically disqualify compensation from being performance based for Section 162(m) purposes? Arguments can be made that this should not be the result, but the Service is not likely to agree.<sup>46</sup>

**SHAREHOLDER APPROVAL**

The third requirement of the performance-based-compensation exception is that the material terms under which the compensation is to be paid (including performance goals) must be disclosed to and subsequently approved by the shareholders of the publicly held corporation.<sup>47</sup> Disclosure and shareholder approval can occur anytime after the compensation committee sets the goals as long as it happens before the compensation is paid. The "material terms" include:

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- (1.) The employees eligible to receive compensation.
- (2.) A description of the business criteria on which the performance goal is based.
- (3.) Either the maximum compensation that could be paid to any employee or the formula used to calculate the compensation to be paid to the employee if the performance goal is attained, except that, for a formula based, in whole or in part, on a percentage of salary or base pay, the maximum dollar amount of compensation that could be paid to the employee must be disclosed.

**Eligible employees.** A general description of the eligible employees by title or class (such as the CEO and vice presidents, or all salaried employees, all executive officers, or all key employees) is sufficient. Query whether it would be permissible to have a performance-based plan open to "all employees."

**Business criteria.** Disclosure of the business criteria on which the performance goal is based need not include the specific targets that must be satisfied under the performance goal. For example, if a bonus plan provides that a bonus will be paid if earnings per share increase by 10%, the specific percentage target need not be disclosed to shareholders as long as the plan's earnings-per-share criterion is disclosed. If employees may be granted stock options or SARs under a plan, no specific description of business criteria is required if the grants or awards are based on a stock price that is not less than current FMV.

If the compensation committee determines, based on the facts and circumstances, that the information is confidential commercial or business information, the disclosure of which would have an adverse effect on the publicly held corporation, it does not have to disclose such information.<sup>48</sup> The disclosure to shareholders must state only that the committee has so determined. Confidential information does not include the identity of an executive or the class of executives to which a performance goal applies.

**Maximums.** The Regulations make it clear that the ability to withhold confidential information does not eliminate the requirement that disclosure be made of the maximum amount payable to an individual under a performance goal. Such disclosure must be specific enough so that shareholders can determine the maximum amount of compensation that could be paid to any employee during a specified period.<sup>49</sup> For example, if compensation attributable to the exercise of stock options is the difference between the exercise price and the current value, disclosure would be required of the maximum number of shares for which grants may be made to any employee and the exercise price of those options (e.g., FMV on date of grant). Shareholders could then 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.

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**Additional disclosure.** Once the material terms of a performance goal are disclosed to and approved by shareholders, no additional disclosure or approval is required unless the compensation committee changes the material terms of the performance goal.<sup>50</sup> If the compensation committee has authority to change the targets under a performance goal after shareholder approval of the goal (e.g., by setting a new annual target each year), material terms of the performance goal must be disclosed to and reapproved by shareholders no later than the first shareholder meeting that occurs in the fifth year following the year in which shareholders previously approved the performance goal.<sup>51</sup>

**Voting.** In order to reflect the fact that certain shares may have more than one vote, and to properly deal with abstentions, Reg. 1.162-27(e)(4)(vii) provides that the material terms of a performance goal are approved by shareholders if, in a separate vote, a majority of the votes cast on the issue (including abstentions to the extent abstentions are counted as voting under applicable state law) are cast in favor of approval. In addition, the Regulations provide that the shareholders of the publicly held member of an affiliated group are treated as the shareholders of all members of the affiliated group.<sup>52</sup>

#### **CERTIFICATION**

The fourth requirement of the performance-based-compensation exception is that before the compensation is paid, the compensation committee certify that the performance goals and any other material terms were satisfied. Reg. 1.162-27(e)(5) states that certification is not required for compensation attributable solely to the increase in the company's stock.

#### **PRIVATE-TO-PUBLIC EXEMPTIONS**

Under Reg. 1.162-27(f) , a company that goes public is exempt from Section 162(m) for any remuneration paid pursuant to a compensation plan or agreement entered into before going public. If a corporation becomes publicly held in connection with an initial public offering (IPO), this "going public relief" applies only if the compensation agreement is disclosed in the prospectus accompanying the IPO.

The going public relief may be relied on until the earliest of:

- (1.) The expiration of the plan or agreement.
- (2.) The material modification of the plan or agreement, within the meaning of Reg. 1.162-27(h)(1)(iii) .
- (3.) The issuance of all employer stock and other compensation that has been allocated under the

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plan.

(4.) 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 the 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).

The going public relief will apply to any compensation received pursuant to (1) the exercise of a stock option or SAR or (2) the substantial vesting of restricted property, granted under a plan or agreement described above if the grant occurs on or before the earliest of the events specified above.

A corporation that is a member of an affiliated group that includes a publicly held corporation is considered publicly held and, therefore, cannot rely on this going public relief. Nevertheless, if such a subsidiary becomes a separate publicly held corporation (whether by spinoff or otherwise), any remuneration paid to covered employees of the new publicly held corporation will satisfy the exception for performance-based compensation if either the "prior establishment and approval" requirements or the "transition period relief" requirements described below are met.

**Prior establishment and approval.** Remuneration will come within going public relief if, before the subsidiary becomes publicly held, the outside directors and shareholders establish and approve the performance-based compensation for the executives of the new corporation. In addition, the certification required by Reg. 1.162-27(e)(5) must be made by the compensation committee of the new publicly held corporation, except that if the performance goals are attained before the corporation becomes a separate publicly held corporation, the certification may be made by the compensation committee of the publicly held corporation.

Transition period relief requirements. Where shareholder approval of the performance-based compensation is not obtained before the spinoff, an eligible taxpayer still will get relief from the shareholder approval requirement for compensation paid, or stock options, SARs, or restricted property granted, prior to the first regularly scheduled meeting of the shareholders of the new publicly held corporation that occurs more than 12 months after the date the corporation becomes a separate publicly held corporation.

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To be eligible for this relief, the remuneration must satisfy all of the requirements of Regs.

1.162-27(e)(2) , (3) , and (5) . The outside directors of the corporation before it becomes a separate publicly held corporation, or the outside directors of the new publicly held corporation, may establish and administer the performance goals for the covered employees of the new publicly held corporation for purposes of satisfying the performance goal and outside director requirements. The compensation committee certification required must be made by the committee of the new publicly held corporation. Compensation paid, or stock options, SARs, or restricted property granted, on or after the date of that meeting of shareholders must satisfy all requirements of Reg. 1.162-27(e) , including the shareholder approval requirement, in order to satisfy the requirements for performance-based compensation.

### **EXCESS PARACHUTE PAYMENTS**

Under Section 162(m)(4)(F) and Reg. 1.162-27(g) , the \$1 million deduction limit is reduced (but not below zero) by the amount (if any) that would have been included in the compensation of the covered employee for the tax year but for being disallowed by reason of Section 280G.

Example: During one tax year, a corporation pays \$1.5 million to a covered employee and no portion satisfies the exception for commissions or for qualified performance-based compensation. Of the total, \$600,000 is disallowed as an excess parachute payment under Section 280G(b)(1) . Because the excess parachute payment reduces the \$1 million limitation of Section 162(m) , the corporation can deduct \$400,000, and \$500,000 of the otherwise deductible amount is nondeductible by reason of Section 162(m).

### **TRANSITION RULES**

Section 162(m)(4)(D) provides that the \$1 million deduction limit does not apply to compensation payable under "a written binding contract that was in effect on February 17, 1993" and not modified thereafter in any material respect ("binding contract"). The grandfather rule in Reg. 1.162-27(h)(1) protects the deduction for future payouts on written contracts entered into before 2/18/93, and written awards made before 2/18/93 so long as the corporation's obligation under the old contract or award is not subject to discretion, i.e., the corporation is obligated to make the payment.

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A contract is not binding unless, under state law, the corporation is obligated to pay the compensation if the employee performs services. A contract renewed after 2/17/93 is treated as a new contract. A written binding contract that is terminable or cancellable by the corporation after 2/17/93 without the employee's consent is also treated as a new contract as of the date that any such termination or cancellation, if made, would be effective.<sup>53</sup> For example, if a contract provides that it will be automatically renewed as of a certain date unless either the corporation or the employee gives notice of termination of the contract at least 30 days before that date, the contract is treated as a new contract as of the date that termination would be effective if that notice were given. Similarly, if the terms of a contract provide that the contract will be terminated or cancelled as of a certain date unless either the corporation or the employee elects to renew within 30 days of that date, the contract is treated as renewed by the corporation as of that date. Alternatively, if the corporation will remain legally obligated by the terms of a contract beyond a certain date at the sole discretion of the employee, the contract will not be treated as a new contract as of that date if the employee exercises the discretion to keep the corporation bound to the contract. A contract is not treated as terminable or cancellable if it can be terminated or cancelled only by terminating the employment relationship.

If a compensation plan or arrangement meets the binding contract requirements of the Regulations, the compensation paid to an employee pursuant to the plan or arrangement will not be subject to the deduction limit of Section 162(m) even though the employee was not eligible to participate in the plan as of 2/17/93. For this exception to apply, Reg. 1.162-27(h)(1)(ii) states that the employee must have been employed on 2/17/93 by the corporation that maintained the plan or arrangement, or the employee had the right to participate in the plan or arrangement under a written binding contract as of that date.

The binding contract exception does not apply if there is a material modification of the contract, i.e., when the contract is amended to increase the compensation payable to the employee ( Reg. 1.162-27(h)(1)(iii)(A) ). If a binding written contract is materially modified, it is treated as a new contract entered into as of the date of the material modification. Thus, amounts received by an employee under the contract prior to a material modification are not affected, but amounts received subsequent to the material modification are not treated as paid under a binding contract.

Acceleration or deferral of payments of compensation under a binding contract will not destroy the grandfather treatment under Section 162(m) as long as the modifications of the amounts payable are similar to those discussed above in connection with permissible discretion.<sup>54</sup> The adoption of a

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supplemental contract or agreement that provides for increased compensation, or the payment of additional compensation, is a material modification of a binding contract where the facts and circumstances show that the additional compensation is paid on the basis of substantially the same elements or conditions as the compensation that is otherwise paid under the written binding contract.<sup>55</sup> Nevertheless, a material modification of a binding contract does not include a supplemental payment that is equal to or less than a reasonable cost-of-living increase over the payment made in the preceding year under that written binding contract.<sup>56</sup> In addition, a supplemental payment of compensation that satisfies the requirements of qualified performance-based compensation will not be a material modification.

**Outside directors.** A director who is a disinterested director under SEC rules is treated as satisfying the requirements of an outside director under the Regulations until the first meeting of shareholders at which directors are to be elected that occurs after 1995 ( Reg. 1.162-27(h)(2) ).

**Previously approved plans.** Any compensation paid under a plan or agreement approved by shareholders before 12/20/93 satisfies the outside director and shareholder approval requirements of the Regulations, provided that the directors administering the plan or agreement are disinterested directors and the plan was approved by shareholders under appropriate SEC rules ("transition plan").<sup>57</sup> In addition, for purposes of satisfying the performance-goal requirements relating to stock options and SARs, Reg. 1.162-27(h)(3) treats a transition plan or agreement as stating a maximum number of shares with respect to which an option or right may be granted to any employee if the plan or agreement that was approved by the shareholders provided for an aggregate limit, consistent with Rule 16b-3(b), 17 C.F.R. section 250.16b-3(b) , on the shares of employer stock with respect to which awards may be made under the plan or agreement.

This transition rule may be relied on until the earliest of:

- (1.) The expiration or material modification of the plan or agreement.
- (2.) The issuance of all employer stock and other compensation that has been allocated under the plan.
- (3.) The first meeting of shareholders at which directors are to be elected that occurs after 1996.

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This transition rule applies to any compensation received pursuant to the exercise of a stock option or SAR, or the substantial vesting of restricted property, granted under a transition plan or agreement if the grant occurs on or before the earliest of the events specified above. Any other types of compensation paid after the earliest of these events will be subject to the full panoply of the Section 162(m) rules.<sup>58</sup>

**EFFECTIVE DATES**

Under Reg. 1.162-27(j), the Regulations apply generally to compensation that is otherwise deductible by the corporation in a tax year beginning after 1993. Nevertheless, compensation paid prior to the delayed effective dates by a subsidiary that becomes a separate publicly held corporation will not be subject to the \$1 million deduction limit if the conditions of the transition rule are satisfied. In addition, there are several other transition rules affecting the date on which remuneration is considered paid to an outside director, bonus pools, and compensation based on a percentage of pay.

**CONCLUSION**

Section 162(m) appears to have had the unintended effect of increasing the compensation of senior executives. According to a recent Wall Street Journal special on executive pay, the \$1 million compensation deduction cap has made \$1 million the new pay standard, and is the apparent reason for average raises of 22% for CEOs of Fortune 200 companies with salaries under \$600,000 between 1992 and 1994.<sup>59</sup>

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1

See Barker and Sollee, "Stock Options Can Ease the Impact of the RRA '93 \$1 Million Compensation Cap," , and "IRS Issues Guidance for \$1 Million Cap on Compensation," , discussing the enactment of Section 162(m) and the issuance of EE-61-93, 12/15/93 (the 1993 Proposed Regulations), and Notice 94-2, 1994-1 CB 326 . See also "Time for Setting Performance Goals Extended Again," , discussing Notice 94-68, 1994-1 CB 376 . The revisions in EE-61-93, 12/1/94 (the 1994 Proposed Regulations) were analyzed in Creech, "Amendments to \$1 Million Cap Prop. Regs. Helpful but More Complex Than Was Hoped," .

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2

See also H. Rep't No. 103-213, 103d Cong., 1st Sess. 585 (1993) (the RRA '93 Conference Report); Reg. 1.162-27(c)(1)(i) .

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The Preamble to the 1993 Proposed Regulations noted that questions had arisen as to the application of Section 162(m) to master limited partnerships whose equity interests had to be registered under the 1934 Act and that, beginning in 1997, may be taxed as corporations: "Whether these partnerships would be publicly held corporations within the meaning of section 162(m) and, if so, the manner in which they would satisfy the exception for performance-based compensation is currently under study and is not addressed in these proposed regulations. If necessary, guidance as to the application of section 162(m) to these entities will be provided in the future."

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3

17 C.F.R. section 240.12b-3 . In the absence of a separate definition under the Code of "common equity security," it appears that in Section 162(m) Congress was trying to cross-reference the 1934 Act definition.

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4

"If a corporation that otherwise is not required to register its equity securities does so in order to take advantage of other procedures with regard to public offerings of debt securities," that corporation is not considered publicly held. RRA '93 Conference Report, Note 2 supra .

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5

Reg. 1.162-27(c)(6), Examples 3 and 4 . The same rule applies in determining the status of an affiliated company.

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6

17 C.F.R. section 240.12g3-2(c) .

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7

See generally 17 C.F.R. sections 240.12a-4 , -5 , -6 .

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8

Reg. 1.162-27(c)(6), Example 2 .

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9

Under Reg. 1.162-27(c)(2)(ii) , only those employees who appear on the "summary compensation

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table" under the SEC's executive compensation disclosure rules, as set forth in Item 402 of Regulation S-K, 17 C.F.R. section 229.402 , under the 1934 Act, and who also are employed on the last day of the tax year are "covered employees."

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10

As amended in December of 1993, Regulation S-K also requires disclosure for up to an additional two executives, for a total of as many as six executives in addition to the CEO; 17 C.F.R. section 229.402(a)(2) . Section 162(m) has not been amended to pick up this modification. The Regulations under Section 162(m) properly do not reflect the new top-6 executive rule either, as there does not appear to be statutory authority for such a change.

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11

17 C.F.R. section 220.10(a)(2) . See also 17 C.F.R. section 240.14(a)101 , Item 8.

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12

17 C.F.R. sections 240.12b-1 ; 240.13a-1 ; 249.220f(b) ; 240.14(a)101 , Item 8, by reference to 17 C.F.R. section 229.402 ; 240.14c-3(a)(1) . The S-K top-four rules do not apply to shareholder disclosure under Section 14(d) . See generally 17 C.F.R. sections 240.14d-6 , -9 , -100 , -101 , -102 , -103 .

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13

Reg. 1.162-27(c)(2)(ii) ; see also the RRA '93 Conference Report, Note 2 supra ("Covered employees are defined by reference to the Securities and Exchange Commission (SEC) rules governing disclosure of executive compensation").

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14

Shareholder approval means the approval by a majority of the votes cast, not by a majority of all the outstanding shares. Reg. 1.162-27(e)(4)(vii) .

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15

The status of a director as an employee or former officer is determined on the basis of the facts at the time that the individual is serving as a director on the compensation committee. Reg. 1.162-27(e)(3)(vi) . The final Regulations were revised to clarify that a former officer of either a spun-off or liquidated corporation that formerly was a member of the affiliated group is not precluded from serving on the

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compensation committee of the publicly held member of the affiliated group. See Reg. 1.162-27(e)(3)(ix), Example 1 .

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16

Entity is defined quite broadly to include unincorporated entities in much the same manner as Section 414(c) . Reg. 1.162-27(e)(3)(v) .

---

17

Reg. 1.162-27(e)(3)(ix), Examples 3 and 4 , illustrate what will be considered indirect remuneration to an outside director.

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18

See Reg. 1.162-27(e)(3)(ix), Example 2 .

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19

See Reg. 1.162-27(e)(3)(ix), Example 6 .

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20

As demonstrated in Ltr. Rul. 9601032 , the Service is following a technical reading of the 90-day requirement. In a leap year, for a calendar-year taxpayer the 90th day after the start of the performance period-if it relates to the tax year-will be March 31, not April 1.

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21

Reg. 1.162-27(e)(2)(vii), Example 13 ; see discussion in the text, below, regarding the effect of such adjustments on whether the compensation committee has retained impermissible discretion.

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22

See Reg. 1.162-27(e)(2)(vii), Examples 1, 2, and 3 . The latter example put to rest some concerns that a corporation with a history of profits might not have been able to meet the substantially uncertain requirement.

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23

See Reg. 1.162-27(e)(2)(vii), Example 4 .

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24

When a taxpayer first becomes eligible to participate in a deferred compensation plan during the tax year, the Service has allowed the newly eligible participant to make a deferral election with respect to services performed after his eligibility date; Rev. Proc. 92-65, 1992-2 CB 428 . IRS failed to adopt a similar rule in the Section 162(m) Regulations.

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25

At least half of Fortune 500 companies use some kind of peer review system to determine executive compensation. "Executive Pay," Wall St. J., 4/11/96, page R8.

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26

Regs. 1.162-27(e)(2)(i) and (ii) . Query whether it would be sufficient if all employees of the corporation were described as being eligible for performance compensation, or if it is necessary to specify a lesser-included group.

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27

See the Preamble to the 1993 Proposed Regulations for the rationale for permitting negative discretion.

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28

On the other hand, some publicly held corporations may be hesitant to use the "discretion-to-reduce" technique because the corporation must disclose the high potential compensation number to shareholders (under the shareholder approval requirements described in the text, below).

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29

This type of bonus arrangement would not qualify for the performance-based-compensation exception because a third party could not calculate each executive's bonus.

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30

See Reg. 1.162-27(e)(2)(vii), Examples 6, 7, and 8 , which attempt to elucidate the rules regarding bonus pools.

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31

The calculation of earnings per share (EPS), return on equity (ROE), and return on assets (ROA) entails "subjective" determinations. For example, where a corporation grants a performance-based award to a covered employee by reason of achieving an EPS goal, the corporation's management makes and its auditors certify a number of "subjective" judgments in applying generally accepted accounting principles (GAAP) to determine EPS. Since it can be argued that EPS is determined for substantial noncompensatory business purposes (e.g., for reports to shareholders, lenders, securities analysts, etc.), it should be legitimate to conclude that subjective judgments in the calculation of EPS are not prohibited discretion. Can a similar argument be made with respect to awards based on ROA?

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32

Reg. 1.162-27(e)(2)(vii), Example 13 , provides that an adjustment to earnings specified in the plan will not be an exercise of impermissible discretion because it is made pursuant to the plan provisions.

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33

Reg. 1.162-27(e)(2)(iii)(B) . Some commentators requested that payment be permitted before the attainment of the goal as long as the compensation committee could make a good-faith determination that the goal had been met. The Regulations were not modified to allow for this.

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34

Reg. 1.162-27(e)(2)(vii), Example 15 , provides that the Moody's Average Corporate Bond Yield index can be used as a measuring device for additions to performance-based compensation as it reflects a reasonable rate of interest.

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35

See Reg. 1.162-27(e)(2)(vii), Examples 14 and 16 . Under this standard, it would be permissible to use the actual investment allocation of an executive's savings account under a tax-qualified plan. In contrast, it would not be permissible to use the cost of capital to the company as a measuring device.

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36

Reg. 1.162-27(e)(4)(vi) provides that once the material terms of a performance goal are disclosed to and approved by shareholders, no additional disclosure or approval is required unless the compensation committee changes the material terms of the performance goal. See Ltr. Rul. 9613006 . It may be

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possible to get a favorable private letter ruling in a situation such as that described in the text.

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37

Reg. 1.162-27(e)(2)(vii), Example 11 . The status of dividend equivalents is discussed below.

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38

See the Preamble to the 1994 Proposed Regulations. The modifier "limited" appears only in the Preamble, not in the body of the rules.

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39

See also the discussion in the text, below, of what kinds of supplemental payments constitute a material modification of a written binding contract.

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40

For example, a corporation may use both a discretionary incentive plan based on quantitative and qualitative standards and a nondiscretionary plan. Based on the regulatory language, the corporation may be faced with the dilemma of proving that the payments made under its discretionary plan were not made because an employee failed to satisfy the requirements of the nondiscretionary plan. For example, a covered employee with a salary of \$500,000 has an incentive plan with various targeted EPS goals. If the maximum goal is met, her bonus will be \$3 million and if a lesser target is met her bonus will be \$1 million. Only the intermediate target is met, so the executive gets the \$1 million bonus. If she also receives a \$2 million discretionary bonus, will that jeopardize the deductibility of the \$1 million bonus? Under the aggregation test, that bonus would call into question the legitimacy of the incentive plan.

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41

The language of the Regulations does not seem to permit a plan to satisfy this requirement by setting the maximum number of shares per employee as a percentage of outstanding shares.

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42

Reg. 1.162-27(e)(2)(vi) ; See Reg. 1.162-27(e)(2)(vii), Examples 9 and 11 .

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43

See Reg. 1.421-7(e)(2) . See also Prop. Reg. 1.422A-2(e)(1) , adopting Reg. 1.421-7(e)(2) for

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incentive stock options.

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44

Regs. 1.162-27(e)(2)(vi)(B) and (e)(2)(vii), Example 10 .

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45

RRA "93 Conference Report, Note 2 supra , page 587.

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46

The Preamble to the 1993 Proposed Regulations had this statement regarding Section 83(b) :  
"Questions have arisen as to the application of the deduction limitation under section 162(m) where an employee makes an election to accelerate recognition of income under section 83(b). These proposed regulations do not address this issue and comments are specifically requested."

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47

Section 162(m)(4)(C)(ii) ; Reg. 1.162-27(e)(4) .

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48

Regs. 1.162-27(e)(4)(iii) and (ix), Example 5 . Whether the material terms of a performance goal are adequately disclosed to shareholders is generally determined under the same standards as apply under the 1934 Act.

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49

As noted, 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. See Reg. 1.162-27(e)(4)(ix), Examples 1 through 4 .

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50

An increase in the maximum dollar amount of compensation under the plan is a material term necessitating new shareholder approval. See Reg. 1.162-27(e)(4)(ix), Example 4 .

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51

In Ltr. Rul. 9613006 , the Service ruled that certain changes in a corporation's stock option and

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restricted stock plan would not be a change in the material terms of the performance goal, within the meaning of Reg. 1.162-27(e)(4)(vi) . See "Shareholder Approval Not Required for Employer's Amendment to Stock Option Plan," .

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52

Reg. 1.162-27(e)(4)(viii) . For example, if one of the five covered employees of an affiliated group is an employee of a wholly owned subsidiary of a publicly held parent corporation, the shareholders of the parent would be required to approve the performance-based compensation of that covered employee along with that of the four covered employees who are employees of the publicly held parent.

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53

Reg. 1.162-27(h)(1)(iv), Example 1 .

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54

Reg. 1.162-27(h)(1)(iii)(B) . See text accompanying notes 27 through 36, supra.

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55

Reg. 1.162-27(h)(1)(iii)(C) . Under this standard, if a binding contract provides for a salary of \$3 million plus the payment of a discretionary bonus, it is likely that the IRS will take the position that the payment of such a bonus will "ungrandfather" the contract. The Service's theory would be that the bonus is paid on the basis of substantially the same elements or conditions as the compensation (salary) that is otherwise paid under the written binding contract. See the discussion in Note 56 , infra.

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56

Reg. 1.162-27(h)(1)(iii)(C), Examples 2 and 3 , indicates what will and will not be a material modification in this respect. Example 3 provides that restricted stock, since it is based on stock price and continued employment, is not paid on substantially the same elements and conditions as salary. In Example 2, the salary increase, characterized by the Service as a supplemental payment, looks like a bonus, which the Service concluded was paid on substantially the same elements and conditions as salary.

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57

Rule 16b-3(b), 17 C.F.R. section 240.16b-3(b) , under the 1934 Act, or Rule 16b-3(a), 17 C.F.R.

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section 240.16b-3(a) (as contained in 17 C.F.R. part 240 revised 4/1/90).

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58

Commentators had asked the Service to extend this transition rule to cover other stock-based compensation and deferred compensation in general. The Preamble to TD 8650 notes that, after careful consideration of the comments received, the IRS and Treasury concluded that there is not adequate justification for a further expansion of the 1994 expansion of the prior regulatory transition relief for previously approved plans and agreements, or the other similar relief provisions added in 1994.

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59

See "Executive Pay," Wall St. J., Note 25 supra , page R4, quoting Executive Compensation Reports, a newsletter based in Fairfax Station, Virginia.

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