SPECIAL REPORT

TAX ANALYSTS

CODE SECTION 162(m) — NEW $1 MILLION DEDUCTION LIMITATION ON EXECUTIVE COMPENSATION

by Jack S. Levin, George B. Javaras, and William R. Welke

Jack S. Levin, George B. Javaras, and William R. Welke are partners in the law firm of Kirkland & Ellis. This article is part of a soon-to-be-published update to a multivolume set of books entitled *Mergers, Acquisitions and Leveraged Buyouts*, by Martin D. Ginsburg and Jack S. Levin.

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In this article, Levin, Javaras, and Welke analyze and critique new section 162(m) which places a $1 million limitation on the deduction that an employer may take for compensation to executives of publicly held corporations, including the spread in NQOs and other types of noncash compensation. The authors describe the six important exceptions to the $1 million deduction limitation which allow a corporation to deduct compensation in excess of $1 million to its top executives. The most important and complex of these exceptions is for certain preestablished objective nondiscretionary performance-based compensation approved by an independent board committee and shareholders.

After section 162(m)'s effective date (taxable years beginning after December 31, 1993), a publicly held corporation must either (a) forgo federal income tax deductions, (b) change compensation practices for top executives to comply with the performance-based-compensation exception for compensation exceeding $1 million, or (c) defer such compensation until the recipient ceases to be a top executive covered by this provision.

The executives covered by section 162(m) are generally defined by reference to shareholder disclosure requirements of the 1934 Securities Act. The article describes a number of ambiguities and discontinuities in reconciling the language of section 162(m) with the 1934 act disclosure requirements.

A privately held corporation must also consider the effect of section 162(m) in structuring compensatory arrangements if it might go public before the end of the tax year in which the compensation would be deductible.

The authors review a number of complexities which arise in an acquisition context. For example, how is section 162(m) applied where publicly held T's year is cut short when P acquires T and T never files a proxy statement reporting executive compensation for the acquisition year? Where an executive receives part of his compensation during a year from T (pre-acquisition) and part from publicly held P (post-acquisition)? Where P assumes T's grandfathered compensation arrangements?

Finally, the authors believe that section 162(m) is an expression of political and social engineering rather than sound tax policy and that it should (but is not likely to) be repealed.

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I. Introduction

The 1993 Tax Act adds to the code a controversial provision, section 162(m), disallowing a corporation's federal income tax deduction for compensation to an executive in excess of $1 million during a corporate taxable year. The $1 million deduction limitation covers all types of compensation, including cash, property, options, etc. However, there are a series of important exceptions, including:

- compensation paid by a privately held corporation,
- compensation paid to an executive other than one of the corporation's top five officers,
- performance-based compensation which is based on a pre-established objective nondiscretionary formula and also meets certain shareholder and independent director approval requirements, and
- compensation which is deductible in a corporate tax year beginning before January 1, 1994.

A publicly traded corporation is generally left with two choices. It can *either:*

- forgo a federal income tax deduction for compensation during a taxable year in excess of $1 million to any one of its top five officers, or
- change its compensation practices so that a covered executive's salary and discretionary (nonformula) bonuses do not exceed $1 million in any year and any compensation in excess of $1 million *either* (i) consists of formula performance-based bonuses, SARs, restricted stock, or stock options structured to comply with the requirements of the performance-based-compensation exception, or (ii) is deferred to a time when the recipient is no longer one of the corporation's top five officers.

A privately held corporation must also consider these two alternatives, even for compensatory arrangements entered into while it is privately held, if the corporation goes (or might go) public before the end of the corporate tax year in which the compensation would be deductible.

Part II of the article outlines the $1 million deduction limitation, the complex exceptions to the deduction limitation, and a number of uncertainties and pitfalls. Part III discusses the application of the new rules to a private corporation that goes public. Part IV discusses the application of the new rules in the context of a merger or acquisition.

II. The Deduction Limitation and Exceptions

A. Basic Deduction Limitation

No corporation can deduct more than $1 million per executive per year for compensation to an executive, unless one of the six exceptions described in B through G below applies.[1] Section 162(m) does not eliminate the requirement that, to be deductible, compensation be "a reasonable allowance for salaries or other compensation for personal services actually rendered."[2] Thus, even if compensation meets one of the exceptions to the $1 million deduction limitation, the compensation must still be "reasonable" in order to be deductible.

Compensation includes all amounts, whether paid in cash, stock options, the corporation's stock or other property.

Compensation for this purpose includes all amounts, whether paid in cash, stock options, the corporation's stock or other property, and is taken into account for the corporation's taxable year in which such compensation would otherwise be deductible.

- The spread in a nonqualified option ("NQO") is generally taken into account at exercise.
- The spread in an incentive stock option (an "ISO") is generally taken into account when (and only if) the executive makes a "disqualifying disposition" of the stock received on exercise of the ISO.
- Deferred compensation is generally taken into account when paid.
- Restricted stock (i.e., stock subject to vesting[3]) is generally taken into account (a) when transferred to the executive (if the executive chooses to be taxed on the receipt of the stock by making a section 83(b) election) or (b) at vesting (if the executive chooses to be taxed on the stock at vesting by making no section 83(b) election).
- Phantom stock is generally taken into account when paid (in cash or unrestricted stock).

The $1 million deduction limitation does not cover compensation that is in the form of (i) contributions to or payments from qualified retirement plans or (ii) nontaxable fringe benefits.[4]

The $1 million deduction limitation is reduced by the amount of any nondeductible golden parachute payments the corporation makes to the executive in the

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[1]Section 162(m)(1).

[2]Section 162(a)(1).

[3]In tax parlance, stock subject to a substantial risk of forfeiture or "SRF". *See* section 83.

[4]Section 162(m)(4)(E).

same taxable year.[5] This unwarranted provision unfairly penalizes a corporation twice for excess golden parachute payments and, in the authors' opinion, should be repealed.

B. Exception #1: Privately Held Corporation

The $1 million deduction limitation does not cover compensation paid by a corporation that is privately held throughout the corporation's taxable year in which the compensation is deductible.[6]

For this purpose, a corporation is privately held if it has no class of "common equity securities" required to be registered under section 12 of the Securities Exchange Act of 1934 (the "1934 act").[7] Thus, a corporation is privately held as long as it (i) has no class of common equity securities traded on a national securities exchange and (ii) does not have both 500 or more holders of a class of common equity securities and $5 million or more of consolidated assets (based on its balance sheet prepared in accordance with GAAP).[8]

A corporation is privately held if it has no class of 'common equity securities' required to be registered.

A corporation that is publicly held at year end is apparently treated as publicly held for the entire year. Thus, if a privately held corporation goes public, it loses the benefit of exception #1 for any compensation otherwise deductible in the taxable year of the initial public offering ("IPO") or in any subsequent taxable year in which it remains public. This is true even with respect to binding arrangements entered into while the corporation was privately held.[9]

Where a corporation that is publicly held at the beginning of a taxable year goes private before the end of the year (e.g., because it is acquired by another corporation or because it has fewer shareholders or assets at year end), it is unclear whether the corporation may take advantage of this exception #1. There are several possibilities:

- The corporation may take advantage of exception #1 for the entire year because it is privately held at the end of the year.
- The corporation may take advantage of exception #1, but only with respect to compensation paid while (or allocable to the period during which) it was privately held.
- The corporation may not take advantage of exception #1 at all.

The authors believe that the IRS should allow the corporation to rely on exception #1, at least for the portion of the year in which it is privately held.[10] The impact of this ambiguity is limited by the availability of exception #2 for compensation paid to a person who is not a covered employee. A publicly held corporation that goes private before year end will generally not be required to send its shareholders a proxy statement disclosing executive compensation for the year in which it goes private. For example, if a calendar year corporation goes private in June 1994, it will generally not send its shareholders a proxy statement in March 1995 (disclosing 1994 compensation).

Thus, as discussed in II.C. and IV.A. below, if the IRS were to attempt to apply section 162(m) to the year in which the corporation went private, only compensation paid to the corporation's year-end CEO would appear to be at risk and the corporation's four most highly compensated executives would not be covered employees.

C. Exception #2: Noncovered Employee

The $1 million deduction limitation does not apply to compensation paid to an executive if he or she is not a "covered employee."[11] For this purpose, a "covered employee" means:

- Section 162(m)(3)(A): the CEO, "or . . . an individual acting in such a capacity," "as of the close of the taxable year," *plus*
- Section 162(m)(3)(B): the four highest compensated officers (other than the CEO) whose "total compensation . . . for the taxable year is required to be reported to shareholders under the [1934 act]."[12]

Thus, the definition of the four covered employees in section 162(m)(3)(B) is based on compensation level and the disclosure rules of the 1934 act, while the definition in section 162(m)(3)(A) for the CEO or person acting in that capacity at year end is automatic without regard to compensation level and 1934 act disclosure. Unfortunately, there are important differences between section 162(m) and the 1934 act, which raise a number of issues and may create several opportunities in determining the four covered employees other than the year-end CEO.

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[5]Section 162(m)(4)(F).

[6]Section 162(m)(1).

[7]Section 162(m)(2).

[8]*Publicly held* and *public* are used in this article to describe a corporation that is subject to reporting under section 12 of the 1934 act and which may not, therefore, rely on exception #1. *Privately held* and *private* are used to describe a corporation that is not subject to 1934 act section 12 reporting and which may, therefore, rely on exception #1.

[9]*See* II.E. below for an exception covering a binding written agreement in effect on February 17, 1993, and not modified thereafter in any material respect. *See* III below for a more extensive discussion of the $1 million deduction limitation as applied to a privately held corporation that goes public.

[10]The corporation may be able to insure the availability of exception #1 for the portion of the year in which it is privately held by changing its taxable year, so that the taxable year ends just after it goes private. *See* reg. section 1.442-1(c) and Rev. Proc. 92-13, 1992-1 C.B. 665, allowing a corporation to change its accounting period without IRS consent in certain circumstances. Note Rev. Proc. 92-13 requires that the taxpayer's taxable year and financial accounting year be the same.

[11]Section 162(m)(1).

[12]Section 162(m)(3)(A) and (B).

In general, section 162(m)'s reference to compensation required to be reported to shareholders under the 1934 act refers to disclosure in the corporation's annual proxy statement. The 1934 act requires a publicly held corporation to disclose the compensation of its CEO and four other highest paid executive officers in its proxy statement issued to shareholders in connection with (a) the election of directors or (b) a vote on certain executive compensation arrangements (a "directors proxy").[13, 14]

1. Coordination with the 1934 Securities Act. Under the 1934 act, the CEO and the four other highest compensated executive officers are determined at the end of the last completed fiscal year.[15] Thus, for purposes of a directors proxy issued by a calendar year corporation in, e.g., March 1995, in connection with the 1995 election of directors, the corporation must disclose the compensation of the CEO and four other highest compensated executive officers for the year ended December 31, 1994. This March 1995 proxy statement is then used in ascertaining the four executives (other than the CEO) who are section 162(m) covered employees for 1994.[16]

In determining the four highest compensated officers (other than the CEO), section 162(m) incorporates SEC reporting principles (not tax principles). Thus, where there are differences between SEC principles and tax principles in terms of timing and amount of compensation (as is frequently the case, for example, with respect to deferred compensation, options, restricted stock, etc.), SEC principles control for purposes of selecting the four covered employees.

The $1 million deduction limitation does not apply to compensation paid to an executive if he or she is not a 'covered employee.'

Generally, a corporation uses the same year for SEC and financial reporting on the one hand and tax reporting on the other. However, a corporation is generally permitted to use a tax year different from its SEC-financial accounting year. Where there is such a difference, there may be complications in applying the portion of the covered employee definition that turns on whether the executive is a person whose "total compensation . . . for the taxable year is required to be reported . . . under the [1934 act] by reason of . . . being among the four highest compensated officers for the taxable year (other than the [CEO])."[17] There is certainly ambiguity where the directors proxy reports for a year different than the taxable year.[18]

Section 162(m) incorporates SEC reporting principles (not tax principles) in determining the four highest compensated officers.

Current SEC regulations under the 1934 act do not require disclosure of an executive's compensation in the directors proxy statement if the executive leaves the corporation's employ before the end of the last completed fiscal year.[19] Thus, if an executive of a calendar year corporation leaves the corporation's employ before the close of business on December 31, 1994, the corporation is not required to disclose his 1994 compensation in its March 1995 directors proxy statement (even if he is one of the four highest compensated executive officers for 1994), and hence he is not a section 162(m) covered employee during 1994.

A proposed amendment to the SEC rules[20] would require proxy disclosure with respect to:

(a) Each person who was CEO or acted in that capacity at any time during the year.

(b) The corporation's four most highly compensated executive officers (other than persons subject to disclosure under (a) above) who were serving as executive officers at the end of the year.

(c) Up to two persons (other than persons who must be disclosed under (a) above) who would have been among the four highest compensated executive officers at year end but for the fact that they left the corporation's employ before year end.

This amendment (which is likely to be adopted) would create additional discontinuities and highlight additional ambiguities between the SEC rules and section 162(m). For example, the proposed SEC rule would automatically require disclosure of each person who served as CEO during the year without regard to his compensation, while section 162(m)(3)(A)'s automatic rule refers to only the year-end CEO. If this SEC proposal is adopted, an executive whose compensation is disclosed in the directors proxy because he was CEO during part of a year, but not at year end (an "interim CEO"), would apparently *not* be a covered employee

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[13]SEC Schedule 14A, Item 8; SEC Regulation S-K, Item 402(a)(3).

[14]The 1934 act also requires certain other forms to be filed with the SEC (e.g., Form 10-K). However, these forms generally are not required to be sent by the corporation to all shareholders. Thus, any disclosure of compensation in these forms would apparently not be relevant for section 162(m) purposes, because such disclosure is not "required to be reported *to shareholders*" (emphasis added).

[15]SEC Regulation S-K, Item 402(a)(3).

[16]*See* IV.A. below for a discussion of a situation in which a publicly held corporation is not (because of a merger or acquisition) required to file a directors proxy with respect to a year in which it was publicly held.

[17]Section 162(m)(3)(B).

[18]There would be no ambiguities created with respect to the corporation's taxable-year-end CEO because he is automatically a covered employee without regard to the SEC reporting rules.

[19]SEC Regulation S-K, Item 402(a)(3).

[20]SEC Act Rel. No. 33-7009; SEC Ex. Act Rel. No. 34-32723 (August 6, 1993).

even where his compensation is disclosed in the directors proxy because he was CEO during the year ((a) above) and his compensation would place him among the four highest compensated officers. This surprising result occurs because such an interim CEO is not covered by section 162(m)(3)(A)'s automatic rule (year-end CEO) and is apparently not covered by section 162(m)(3)(B)'s four-highest rule (an employee whose "total compensation . . . is required to be reported to shareholders under the [1934 act] by reason of . . . being among the four highest compensated officers for the taxable year (other than the [CEO])." The reason he is not covered by section 162(m)(3)(B) is that his compensation is automatically reported to shareholders in the directors proxy as an interim CEO, without regard to the level of his compensation.

The interplay between the SEC rules and section 162(m) can produce curious results.

It is certainly possible the IRS might seek to disregard the quoted statutory language — "required to be reported . . . by reason of . . . " — and hence to treat an interim CEO as a covered employee where his compensation puts him in the top four, but such a reading does not appear consistent with the statutory language.

The proposed SEC amendment's inclusion of up to two persons who would have been among the four highest compensated non-CEO executive officers at year end but for the fact that they left the corporation's employ before year end would prevent an executive (other than a CEO) from avoiding covered employee status for a year by retiring just before year end. The amendment also will create a discontinuity, however, between the SEC disclosure rules (which pick up all persons who served as CEO during the year plus up to six other persons) and section 162(m) (which only picks up as covered employees the year-end CEO plus four persons). If the proposed amendment is adopted, the directors proxy will disclose the compensation of (a) all CEOs during the year, (b) the four highest paid year-end executive officers, and (c) each interim executive officer (up to two) if his compensation exceeded that of at least one (b) person. A literal reading, however, of section 162(m)(3) suggests that the section 162(m) covered employees would be only the year-end CEO and the four highest paid executives out of the remaining up-to-six persons who were not CEO at any time during the year and whose compensation was disclosed in the directors proxy.[21]

[21]It may be possible to read section 162(m)(3)(B)'s reference to the corporation's "4 highest compensated officers" as a reference to the 4 highest compensated officers *at year end*, as under the current SEC rules. However, the fact that section 162(m)(3)(B) does not refer to the end of the year seems intentional, especially since section 162(m)(3)(A) explicitly adopted the SEC end-of-the-year test in defining the CEO.

The interplay between the SEC rules and section 162(m) can produce curious results. Consider the following example:

- During 1994, a corporation has three different CEOs, each of whom served for four months (the first two are referred to as interim CEOs and the third as year-end CEO).
- During 1994, the corporation also has four highly compensated executive officers who retire before year end (referred to as interim officers) and four highly compensated executive officers who are serving at year end (referred to as year-end officers).
- These 11 persons (listed in order of their 1994 compensation, calculated in accordance with SEC proxy rules rather than tax rules) are as follows:

Executive	Title	1994 Compensation in millions
A	Interim CEO	$4.0
B	Year-end CEO	2.0
C	Interim officer	1.5
D	Interim officer	1.4
E	Interim officer	1.3
F	Year-end officer	1.2
G	Interim CEO	1.1
H	Year-end officer	0.9
I	Year-end officer	0.8
J	Interim officer	0.7
K	Year-end officer	0.5

Under current SEC rules, the corporation must disclose in its 1995 directors proxy the compensation of executive B (year-end CEO) and executives F, H, I, and K (four highest compensated year-end officers) and these five persons are section 162(m) covered employees with respect to 1994. The corporation's five highest compensated executives for 1994, however, were A, B, C, D, and E. Only one of the five highest compensated executives for the year would be a covered employee.

Under proposed SEC rules, the corporation would be required to disclose the compensation of the following executives:

- A and G (as interim CEOs),
- B (as year-end CEO),
- F, H, I, and K (as the four highest compensated year-end officers), and
- C and D (as the two interim officers whose compensation exceeds at least one of the four reported year-end officers).

The corporation would not be required to report (for SEC purposes) executive E (even though his compensation is higher than the four reported year-end officers), because the SEC rule would require reporting on only two interim officers.

Under section 162(m), the covered employees would be B (as year-end CEO) plus C, D, F, and H (the four highest compensated, including only two interim officers and not including any interim CEOs).

An employee of a nonpublicly held subsidiary of a publicly held parent is apparently not a covered employee.

2. Employees of subsidiaries. Section 162(m) appears to treat employees of a nonpublicly held subsidiary of a publicly held parent differently from the way they are treated under disclosure rules under the 1934 act. Under SEC rules, compensation paid to an employee of a nonpublicly traded subsidiary is clearly required to be disclosed in the publicly held parent's directors proxy where (i) the employee would, if he were an employee of the parent, be among the four highest compensated officers, *and* (ii) the employee is an officer of the subsidiary, *and* (iii) the employee exercises policymaking authority with respect to the parent's business.[22]

Under section 162(m), however, an executive does not appear to be a covered employee subject to the $1 million deduction limitation unless he is an employee of the publicly held parent, even if his compensation as an employee of a subsidiary must be disclosed for SEC purposes in the parent's directors proxy. The definition of covered employee in section 162(m)(3) refers to "any employee of the taxpayer." The "taxpayer" clearly refers back to the publicly held corporation mentioned in section 162(m)(1).

Even in the case of a parent and subsidiary that are members of a consolidated group filing a single consolidated federal income tax return, neither the statute nor the legislative history gives any indication that the members of the group are to be treated as a single corporation for purposes of section 162(m). In contrast, under the golden parachute rules of section 280G, the members of an affiliated group are explicitly treated as a single corporation and any officer of a member of the group is treated as an officer of that single corporation.[23]

3. Payments after status change. Where compensation is *earned* by an executive while he is a covered employee but is not *deductible* until after he ceases to be a covered employee, the $1 million deduction limitation does not apply. Conversely, where compensation is *earned* by an executive before he becomes a covered employee but becomes deductible while he is a covered employee, the $1 million deduction limitation does apply.

This rule is particularly relevant for compensation that is deductible one or more years after grant, when the executive's status may have changed, such as:

- Deferred compensation which is generally deductible when paid.
- An NQO which is generally deductible when exercised.
- Restricted stock (i.e., stock subject to vesting) which is generally deductible at vesting (where the executive makes no section 83(b) election at grant).
- Phantom stock which is generally deductible when paid (in cash or unrestricted stock).

Thus, where compensation otherwise payable to a covered executive exceeds the $1 million deduction limitation, the corporation may want to grant all or a portion of such compensation in the form of deferred compensation which is payable after the covered executive's retirement. Alternatively, the corporation may want to grant NQOs, restricted stock, or phantom stock that will generate a deduction after the covered executive's retirement.[24]

Conversely, a corporation may also find it desirable to structure compensation arrangements to fit the performance-based-compensation exception (exception #3 below), even where the executive is not a covered employee when the arrangement is entered into, if there is any possibility that he may subsequently be a covered employee when the compensation becomes deductible.

4. Effect of mergers and acquisitions. Mergers and acquisitions raise interesting issues regarding application of exception #2. See IV below for a discussion.

D. Exception #3: Performance-Based Compensation

The $1 million deduction limitation does not apply to compensation where *all* four of the following tests are met:

1. The compensation is payable solely on account of attaining one or more nondiscretionary objective performance goals.[25] The legislative history states that the goal(s) must be a "preestablished objective performance formula or standard that precludes discretion [so that] . . . a third party with knowledge of the relevant performance results could calculate the amount to be paid to the executive, . . . includ[ing], for example, increases in stock price, market share, or earnings per share."[26]

Presumably a formula goal will qualify only if it relates to the performance of the corporation or a busi-

[22]SEC Regulation S-K, Instruction 2 to Item 402(a)(3); SEC Rule 3b-7.

[23]*See* section 280G(d)(5).

[24]As noted above, under current SEC rules, an executive's compensation for the corporate year in which he retires is not required to be disclosed in the directors proxy. Thus, compensation to the executive which is deductible in the corporate year in which the executive leaves the corporation's employ (or any subsequent year) is not subject to the $1 million deduction limitation. Proposed amendments to the SEC rules, also described above, would generally eliminate the executive's ability to avoid covered employee status in the year he leaves the corporation's employ, although, even under the amendment, the executive would not be a covered employee for years after the year he leaves the corporation's employ.

[25]Section 162(m)(4)(C).

[26]Conf. Rep. No. 213, 103d Cong., 1st Sess. 586 (1993) (the "1993 Conf. Rep.").

ness segment thereof, not if it relates to (a) any outside standard (e.g., the S&P 500 Index reaching a specified level) or (b) to the executive's employment (e.g., requiring at least five years of continuous employment).

There is risk that an objective performance goal could be disregarded as a sham for this purpose if it is too easy to attain, e.g., where a large car manufacturer agrees to pay its CEO a $2 million bonus next year contingent on the corporation selling at least 1,000 cars. If the IRS takes this approach, there is likely to be substantial controversy as to whether particular performance goals are or are not shams.

Moreover, an even more restrictive interpretation is at least possible. Because all of the examples in the legislative history refer to "increases" in some objective criterion, the legislative history could be read as suggesting that an objective performance goal must involve an *increase* in some objective criterion, such as sales, share price, earnings, etc. We believe the better interpretation of the statute and legislative history is that a performance goal need not involve an increase (and indeed may allow a decrease from a prior year) as long as the goal is a bona fide goal that is not so easy to attain as to be a sham.

Formula goal will qualify only if it relates to the performance of the corporation or a business segment thereof.

a. Cash bonus. For a cash bonus payable to a covered employee to be exempted from the $1 million deduction limitation, the amount of the bonus must be based on a pre-established objective performance formula that precludes discretion and meets the other tests described above.

It appears that a formula bonus would be disqualified from this performance-based-compensation exception where the board (or some other person or group) has a discretionary right to increase or decrease the amount of the bonus calculated pursuant to the formula, e.g., the bonus (as calculated under the formula) can be increased or decreased 20 percent based on the board's judgment as to the quality of the executive's performance. Whether 80 percent of the formula bonus (i.e., the nondiscretionary portion) would qualify for this performance-based-compensation exception (and only the discretionary excess be disqualified) is not clear; it would thus be safer (pending IRS guidance) to structure the plan as two bonuses: a qualifying bonus for 80 percent of the formula amount and a discretionary bonus equal to 0 to 40 percent.

b. Stock option or SAR. The legislative history states that a stock option or stock appreciation right ("SAR") is automatically treated as meeting the performance-goal requirement "because the amount of compensation attributable to the option or [SAR] received by the executive would be based solely on an increase in the corporation's stock price."[27] In short, share appreciation is treated by the new rules as an objective performance goal.

[27]1993 Conf. Rep. at 587.

Share appreciation is treated by the new rules as an objective performance goal.

However, if the option or SAR is in the money at grant, so that "the executive would have the right to receive compensation on the exercise . . . even if the stock price decreases or stays the same," such option or SAR does "not meet the requirements for performance-based compensation."[28] This legislative history would apparently treat an option or SAR that is even 1¢ in the money at grant as not performance-based, even with respect to post-grant appreciation in the underlying stock. A much more sensible result would be to treat the amount an option or SAR is in the money at grant as not qualifying for the performance-based-compensation exception (and hence subject to the $1 million deduction limitation), while treating any post-grant appreciation in the stock as performance-based. We urge the IRS to adopt this approach by regulations or ruling.

c. Restricted stock. The legislative history similarly states that a grant of restricted stock does not qualify for the performance-based-compensation exception because the executive can profit even if the stock value stays the same or declines after grant. The legislative history states that restricted stock may qualify where "the grant or vesting of the restricted stock is based upon the attainment of a performance goal."[29]

Thus, in order for a grant of restricted stock (subject to vesting) to qualify for the performance-based-compensation exception, the grant must either:

- be received as a result of the attainment of one or more objective performance goals established before grant (i.e., similar to the cash bonus rules discussed above), *or*
- be received subject to a vesting restriction that will allow the executive to retain the restricted stock only if one or more objective performance goals are met.[30]

[28]*Id.* However, an NQO which is in the money at grant should qualify for the performance-based-compensation exception where vesting of the option is contingent on attainment of a performance goal. *Cf.* the legislative history quoted in "Restricted stock" immediately below.

[29]1993 Conf. Rep. at 587.

[30]As discussed above, a time-based vesting goal relating to the executive's continued employment would presumably not qualify as a performance goal. In addition, if a corporation grants restricted stock to an executive subject to vesting and the vesting formula gives the corporation discretion over whether the executive will forfeit the stock, the grant of restricted stock will apparently not qualify for the performance-based-compensation exception.

Where restricted stock is granted subject to a vesting restriction that allows the executive to retain the stock only if one or more objective performance goals are met, the corporation should apparently require its executives to forego a section 83(b) election to be taxed on the receipt of restricted stock[31] if the corporation wants the restricted stock to qualify for the performance-based-compensation exception. This is because a section 83(b) election would cause the corporation's deduction to occur before the performance goals can be met and hence apparently prevent compliance with requirements two and four of the performance-based-compensation exception.[32]

Complications may result where an executive is entitled to receive cash dividends on restricted stock otherwise covered by the performance-based-compensation exception. Dividends paid on restricted stock (for which no section 83(b) election has been made) are viewed as compensation income rather than dividends. The right to such dividends may be viewed as a feature that is in-the-money or otherwise not subject to an objective formula performance hurdle. As such, the dividends would create a risk that the entire restricted stock award could fail to qualify for the performance-based-compensation exception.

We believe that the better answer would be for the IRS to view the grant as (a) restricted stock which is performance-based because of an objective formula vesting goal and (b) dividends which are not performance-based. However, the legislative history's suggestion that an NQO that is in the money to any extent at grant fails the performance-based-compensation exception gives us concern. Thus, in the absence of favorable IRS guidance clarifying this issue, it would be safer to (i) give the executive no right to dividends[33] or (ii) accumulate the cash dividends that would otherwise have been paid to the executive on restricted stock and pay them to the executive only as objective performance goals are met.

d. Tandem awards. If an executive receives a tandem award (i.e., an arrangement that allows the executive to choose one, but only one, of two alternative awards), it appears that both alternate awards must qualify for the performance-based-compensation exception if either is to qualify. For example, assume that a corporation grants an executive the right to receive (i) a $2 million bonus or (ii), if an objective performance goal is met and the executive so elects, 100,000 shares of the corporation's stock. However, the executive may receive only one of the two awards.

We believe that the arrangement would be treated as one award for purposes of the $1 million deduction limitation. Because it is in the money at grant (i.e., because the executive is guaranteed at least $2 million), the entire award may fail to qualify for the performance-based-compensation exception even if the executive meets the objective performance goal and chooses to receive the 100,000 shares of the corporation's stock. Even if the IRS adopts a less restrictive, and highly desirable, interpretation of the performance-based-compensation exception, only the excess of the value of the stock over $2 million would qualify for the performance-based-compensation exception.

e. Change-in-control feature. Many compensation plans contain "change-in-control" features that may cause options, SARs, restricted stock, and phantom stock to vest and/or be cashed out on a "change in control."[34] Such a change-in-control feature may affect the ability of awards under a plan to qualify for the performance-based-compensation exception because (where a change in control occurs) the executive may receive compensation even though the underlying objective performance-based goals have not been met.

A change-in-control feature may affect the ability of compensation awards to qualify for the performance-based-compensation exception.

For example, if restricted stock automatically vests on a change in control (without regard to whether the stock has vested in accordance with the underlying performance goals), the change-in-control vesting means that the executive has some chance of retaining the stock even if the performance goals are not met.

A change-in-control feature may not always present a problem. For example, a change-in-control feature that allows a stock option or SAR (granted with an exercise price not less than fair value at grant) to be cashed out for an amount equal to its spread would not be a problem since the existence of the spread automatically means the performance goal has been met.

There is a respectable argument that such a change-in-control feature should be ignored as extremely unlikely to occur, unless and until a change in control actually occurs. The IRS has similarly ignored the tax effect of poison pill plans unless and until they are

[31]The executive should not object to forgoing a section 83(b) election, at least where the executive pays nothing for the restricted stock. In those circumstances, a section 83(b) election would trigger ordinary income for the executive on receipt equal to the value of the stock, determined without regard to the restrictions, and the executive would be entitled to no offsetting tax deduction if the restricted stock were later forfeited. Hence an executive who receives free restricted stock is not likely to make a section 83(b) election, unless the corporation defrays at least part of the tax burden (e.g., through a cash bonus which would further increase the executive's gross income).

[32]Compare the section 280G proposed regulations which ignore the effect of a section 83(b) election in determining the timing of compensation for purposes of the golden parachute rules. Prop. reg. section 1.280G-1, Q/A 12(b).

[33]Corporate law and accounting standards must be reviewed to determine whether elimination of the executive's right to dividends would cause any corporate or accounting problems.

[34]Change-in-control features come in many varieties, sometimes encompassing only hostile changes in control and sometimes both hostile and friendly.

triggered by a change in control.[35] We suggest that the IRS adopt a similar approach in regulations. In such case, the performance-based-compensation exception would be lost only if a change in control actually occurs (unless the underlying performance goals have been met at the time of the change in control).

2. **The performance goal is determined by an independent compensation committee of the board comprised solely of two or more outside directors.**[36] The statute merely states that the independent committee must be composed solely of two or more "outside" directors. The legislative history states that a person is an "outside" director only if he or she:

- is not a current employee of the corporation or a "related" entity,
- was not an officer of the corporation or a "related" entity at any time,[37]
- is not a former employee of the corporation or a "related" entity currently receiving compensation for prior services (other than from a tax-qualified pension plan), *and*
- is not currently receiving compensation for personal services in any capacity other than as a director (e.g., as a consultant).[38]

The independent director committee would be tainted if even one member failed one of these tests.

There is no hint in the legislative history as to the meaning of the word "related." However, an 80-percent-or-more-owned subsidiary of the corporation would certainly appear to be related to the corporation, so that any current employee of such subsidiary or any current or former officer of such subsidiary would be disqualified. It is not at all clear whether a 50-percent-or-more (but less-than-80-percent) owned subsidiary of the corporation is related and resolution of this ambiguity must await issuance of IRS guidance. It is not likely that IRS guidance (when issued) will seek to treat a less-than-50-percent-owned subsidiary as related.

Moreover, it is unclear whether a 50 percent *or* a more-than-50-percent or an 80-percent-or-more *parent* of the corporation is related. It would be illogical to disqualify a representative of the corporation's parent since such a person would appear to be a perfect independent director with the interests of the corporation's stockholders at heart, and we urge the IRS not to do so. However, absent IRS guidance, the issue is not free from doubt.

Where awards are made under a plan (e.g., NQOs are granted under an option plan), we believe that the independent director committee must determine the performance goals to be contained in the plan (generally by approving adoption of the plan). In addition, the independent director committee must determine the performance goals contained in each individual grant under the plan.

Although a corporation is generally not allowed any deduction upon the grant or exercise of an ISO, the corporation should still comply with the performance-based-compensation exception when it grants ISOs because the corporation may be allowed a deduction (subject to section 162(m)) if the executive makes a "disqualifying disposition" of the stock acquired on exercise of the ISO.

3. **The material terms under which the compensation is to be paid (including the performance goals) are disclosed to shareholders and approved by a separate majority shareholder vote.**[39] The legislative history states that this requirement is "generally" met if the shareholders approve:

- the specific terms of the plan,
- the class of executives to which it applies,
- in the case of an option plan, "the option price (or formula under which the price is determined),"[40]
- the maximum number of shares or amount of compensation that can be awarded to any executive, and
- any subsequent material changes to the plan.[41]

The statute and the legislative history require only approval by a majority of the votes cast, not by a majority of all the outstanding shares.[42] Neither the statute nor the legislative history suggests that the majority vote must be calculated by excluding any particular shares, such as those owned by the covered executive.[43]

The legislative history states that the executive's right to receive the compensation must be contingent

[35]*See* Rev. Rul. 90-11, 1990-1 C.B. 11 (no consequences to corporation and shareholders on mere adoption of a poison pill plan).

[36]Section 162(m)(4)(C)(i).

[37]If a director of the corporation serves (or previously served) in a ministerial role as secretary (or assistant secretary) of the corporation, there is substantial risk (absent favorable IRS guidance) that such director would be disqualified as an officer or former officer of the corporation.

[38]1993 Conf. Rep. at 587. The legislative history is wholly silent on whether the payor of this prohibited compensation is only the corporation or may also be a "related" entity.

[39]Section 162(m)(4)(C)(ii).

[40]Generally an option plan states that the option price will not be less than the stock's value at grant date. Such typical language should satisfy this requirement, although it would be safer (pending IRS guidance) for the plan to state that the option price will be equal to 100 percent (or another stated percentage, e.g., 110 percent) of the stock's value at grant, in light of the legislative history's reference to "the option price (or formula under which the price is determined)."

[41]1993 Conf. Rep. at 587-88.

[42]Section 162(m)(4)(C)(ii); 1993 Conf. Rep. at 587. Compare Rev. Rul. 75-256, 1975-2 C.B. 194 (shareholder approval of qualified stock option plan required approval of majority of outstanding shares) with reg. section 1.422-5 and prop. reg. section 1.422A-2(b)(2) (shareholder approval of an ISO plan requires only a majority of the shares voting, unless state law or corporate charter or bylaws establish a different method).

[43]In contrast, the legislative history and proposed regulations under the golden parachute compensation-disallowance rules (section 280G) do contain such an exclusion. *See* H. Rep. No. 426, 99th Cong., 1st Sess. 902 (1985); prop. reg. section 1.280G-1, Q/A 7.

on such shareholder approval.[44] Thus, where shareholder approval will be sought after the grant to, or agreement with, the executive, the documents evidencing the grant or agreement should state that if majority shareholder approval is not subsequently obtained, the grant or agreement is void and the executive forfeits the right to receive the compensation.

Standards for disclosure to shareholders are not entirely clear.

Shareholder approval must be obtained prior to the time when such compensation would otherwise be deductible by the corporation. Because the shareholder vote must be determinative of whether the executive may retain the compensation, the parties will generally find it desirable to obtain shareholder approval as early as possible, i.e., before the arrangements are substantially in the money so that they may appear unfairly generous from the shareholders' standpoint.

The standards for disclosure to shareholders are not entirely clear at this time. The legislative history states that the IRS "should take into account the SEC rules regarding [proxy] disclosure," but does not say that the SEC rules will bind the IRS as to the adequacy of disclosure to shareholders.[45]

The legislative history also suggests that only the "general performance goals" on which executive compensation is based must be disclosed to shareholders. However, the legislative history states also that "it would not be adequate if the shareholders were merely informed that an executive would be awarded $x 'if the executive meets certain performance goals established by the compensation committee.'"[46] Thus, the principal question is whether it is adequate to disclose to shareholders that the compensation is contingent on an objective standard based on sales, EBIT, EPS, etc. or whether it is necessary for the proxy statement to set forth the actual formula itself.[47]

4. Before the compensation is paid, the independent director committee certifies that the performance goals and any other terms were satisfied.[48] The legislative history states that the executive's right to receive the compensation must be contingent on certification. However, according to the legislative history, certification is not required in the case of a stock option or SAR otherwise meeting requirements one through three.[49]

E. Exception #4: Grandfathered Arrangement

The $1 million deduction limitation does not apply to compensation payable under a binding written contract in effect on February 17, 1993, and not modified thereafter in any material respect.[50]

This grandfather rule protects the deduction for future payouts on written contracts entered into on or before February 17, 1993, and written awards made on or before February 17, 1993, 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. However, a mere plan (which permits the corporation to make a future discretionary award or a future contract) is not a binding contract. Thus, the grandfather rule does not protect a post-February 17, 1993, award or contract merely because it is made pursuant to a pre-February 18, 1993, plan.

This grandfather rule protects the deduction for future payouts on written contracts entered into on or before February 17, 1993.

Because a material modification of an old contract or award will result in loss of grandfather protection, the parties should be careful about making any changes to old compensation arrangements. Moreover, any renewal of an old contract or award after February 17, 1993, is considered a new contract.

Any right to terminate or cancel an old contract unconditionally at will (without terminating the employment relationship) causes the contract to be treated as a new contract not subject to grandfather protection as of the date such termination or cancellation would be effective. The legislative history states that a:

> contract that is terminable or cancelable unconditionally at will [without terminating the employment relationship] by either party to the contract without the consent of the other, or by both parties to the contact, is treated as a new contract entered into on the date any such termination or cancellation, if made, would be effective.[51]

This phrase "by both parties" is unclear because all two-party contracts are cancelable if both parties to the contract agree to cancel the contract.[52] Thus, we believe this language should be interpreted to mean only that

[44]1993 Conf. Rep. at 587. If this were not the case, the shareholders would merely be voting on whether the corporation would receive a deduction. Compare prop. reg. section 1.280G-1, Q/A 7 (requiring that compensation to an executive be at risk in a shareholder vote that is a condition to a safe harbor under the golden parachute rules).

[45]1993 Conf. Rep. at 588.

[46]*Id.*

[47]More specific disclosure may be required where shareholders are asked to approve a specific award already made to a specific executive than when shareholders are asked to approve a general plan covering future awards to a number of executives.

[48]Section 162(m)(4)(C)(iii).

[49]1993 Conf. Rep. at 587.

[50]Section 162(m)(4)(D). Proposed regulations under the golden parachute rules may provide some guidance as to the meaning of "material," pending specific guidance under section 162(m)(3)(D). *See* prop. reg. section 1.280G-1, Q/A 50-51.

[51]1993 Conf. Rep. at 589.

[52]Proposed regulations interpreting the effective date and grandfather provisions of the golden parachute rules also carve out of grandfather protection a contract that is cancelable "by both parties to the contract." *See* prop. reg. section 1.280G-1, Q/A 48.

grandfather protection is lost if one or both parties, acting unilaterally (i.e., without the consent of the other), could cancel the contract. Hopefully, regulations will clarify this ambiguity.

The grandfather rule does not protect a post-February 17, 1993, award merely because it was made under a pre-February 18, 1993, plan.

The legislative history seems clearly to indicate that if the executive has the right to cancel the contract, grandfather protection is lost, even where the corporation has no right to cancel the contract. We believe that the corporation's grandfather protection should not be lost if only the executive, and not the corporation, has the unilateral right to terminate the contract.[53] Where the executive has the unilateral right to cancel the contract but does not do so, the corporation is obligated to pay the compensation and should not lose the deduction.

F. Exception #5: Year Beginning Before January 1, 1994

The $1 million deduction limitation does not apply to any amount which is deductible during a corporation's taxable year beginning before January 1, 1994.[54] For a calendar-year corporation, this means the $1 million deduction limitation does not apply to 1993. For a fiscal year corporation with a year ending on (e.g.) June 30, this means the deduction limitation does not apply to its year ending June 30, 1994.

A corporation may therefore want to accelerate the payment or tax accrual of compensation to a covered executive to beat the effective date of the new provision. For a calendar-year corporation:

- Compensation paid to an executive in cash (or accrued for tax purposes) prior to January 1, 1994, is not subject to the $1 million deduction limitation.
- An NQO exercised (or an ISO with a disqualifying disposition) prior to January 1, 1994, is not subject to the limitation (where the stock received on exercise is not subject to post-exercise vesting or where a section 83(b) election is made for stock which is subject to further vesting).
- Restricted stock granted prior to January 1, 1994, avoids the $1 million deduction limitation if the executive makes a section 83(b) election to be taxed on receipt of the stock (rather than on later vesting) which also accelerates the corporation's deduction under section 83(h).

For a fiscal year corporation, the date by which the compensation must be deductible in order to avoid the $1 million deduction limitation is generally later than December 31, 1993. For example, a corporation with a fiscal year ending June 30 can pay a cash bonus as late as June 30, 1994, and avoid the $1 million deduction limitation. Similarly, an NQO can be exercised as late as June 30, 1994.

A special rule applies to a fiscal year corporation that (i) grants restricted stock subject to vesting (or any other property subject to vesting) where the executive makes a section 83(b) election with respect to the grant or (ii) makes a payment under a deferred compensation plan. Under this special rule, such restricted stock grant or deferred compensation payment must generally occur no later than December 31, 1993, to beat the effective date of the new deduction limitation (even though the corporation is on a fiscal year).[55]

G. Exception #6: Commissions

The $1 million deduction limitation does not apply to compensation "payable on a commission basis solely on account of income generated directly by the individual performance of the [executive] to whom such [compensation] is payable."[56]

The good news is that this exception does not require an independent director committee and/or shareholder vote, as does the performance-based-compensation exception. The bad news is that this exception will almost never be useful for a key corporate executive.

Compensation based solely on a percentage of sales made by the executive would qualify for this exception. However, compensation based on a broader performance standard (such as the income or sales produced by the entire corporation or by a business unit) would not qualify for this exception because it would not be based "solely" on sales generated directly by the executive. Hence this is an extremely narrow exception that is unlikely to apply to income earned by the top five officers of a publicly held corporation.

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[53]A pre-February 18, 1993, stock option is clearly grandfathered. However, the executive has the right, by not exercising the option, to "cancel" the option.

[54]Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, section 13211(b) (1993).

[55]This special rule arises because, under section 83(h), the corporation's deduction for a restricted stock grant subject to vesting falls into the corporation's tax year in which or with which the executive's taxable year of receipt ends. Because an executive is almost certainly on a calendar year, a restricted stock grant by a June 30 fiscal year corporation to an executive between January 1, 1994, and June 30, 1994, will be deductible by the corporation in its year beginning July 1, 1994, a year which is covered by section 162(m).

This special rule does not apply to a transfer of property to the executive if the property is not subject to a substantial risk of forfeiture at the time of transfer, e.g., a cash bonus or an NQO exercise (where the stock is not subject to any further vesting after exercise).

The same issue arises for a payment under a deferred compensation plan because the corporation is entitled to deduct such a payment in the corporation's taxable year in which or with which ends the employee's taxable year in which the payment was received. *See* section 404(a)(5) and reg. section 1.404(a)-12.

[56]Section 162(m)(4)(B).

III. Privately Held Corporation That Goes Public

As noted in II.B. above, when a privately held corporation goes public, exception #1 (the exception for compensation paid by a privately held corporation) ceases to apply to any compensation otherwise deductible in the taxable year in which the corporation goes public or in any subsequent taxable year while it remains public. This is true even with respect to binding compensation arrangements entered into while the corporation was privately held.

Thus, if a privately held corporation may go public in the future, it should consider structuring compensation arrangements with its executives so that any compensation in excess of $1 million per year per executive qualifies for the performance-based-compensation exception (exception #3). Because a privately held corporation may not know which of its executives will be "covered employees" if and when it goes public, the corporation may not be able to rely on exception #2 (the exception for compensation paid to executives other than covered employees) even for those executives who are not currently covered employees.

A. Performance-Based-Compensation Exception

Where a privately held corporation goes public, compensation deductible by the corporation during the IPO year or any subsequent year must comply with the four requirements described in II.D. above in order to qualify for the performance-based-compensation exception. Thus, such compensation must be (i) based on one or more pre-established nondiscretionary objective performance goals, (ii) approved by an independent director committee, (iii) approved by shareholder vote, and (iv) paid only after the independent director committee certifies that the performance goal has been met.

> ***The legislative history is silent on whether disclosure in the IPO prospectus will cure the absence of an independent director committee at the time of grant.***

These tests are modified in one respect when applied to an arrangement entered into by a privately held corporation before it goes public. The legislative history states that where a privately held corporation goes public, disclosure in the IPO prospectus (which is sufficient to satisfy the disclosure-to-shareholders rules set forth in II.D.3. above) will satisfy the shareholder vote requirement (unless there is thereafter a material modification of the arrangement).[57]

However, the legislative history is unfortunately silent on whether disclosure in the IPO prospectus will cure the absence of an independent director committee in setting the performance goal as described in II.D.2. above.[58] If disclosure in the prospectus does not cure failure to comply with this requirement at the time of grant, post-grant approval by such an independent director committee may not suffice. Where the arrangement is in the money at the time of the IPO (as would typically be the case), it appears that the arrangement would not, at that time, qualify as a pre-established objective performance goal. See II.D.1.

The authors believe that the IRS should treat the IPO of a privately held corporation (along with full disclosure in the prospectus) as curing not only the shareholder-vote requirement but also the independent-committee-at-grant requirement. However, in the absence of IRS guidance, a privately held corporation (which may go public in the future) wishing to qualify for the performance-based-compensation exception should establish an independent director committee (at the time an executive compensation arrangement is being entered into or granted) to approve executive compensation awards entered into or granted while it is a privately held corporation.

B. Acceleration of Compensation

A privately held corporation that is about to go public may be able to avoid the deduction limitation with respect to compensation that would otherwise not qualify for an exception by accelerating payment of the compensation into a pre-IPO year.

If the corporation is able to accelerate the compensation so that it is deductible in a taxable year during which the corporation was private for the entire year, exception #1 (for compensation paid by a privately held corporation) will apply and the $1 million deduction limitation will not apply. However, acceleration of compensation into the corporation's IPO taxable year will not help because the corporation will not qualify for exception #1 if it is public at the end of the year in which the compensation would otherwise be deductible.

Acceleration of compensation may have side effects. For example, it may affect the corporation's book earnings and hence its IPO price. In addition, acceleration of the corporation's deduction will also accelerate the executive's taxable income.

A privately held corporation that is about to go public may want to change its taxable year to one which ends just prior to the IPO.[59] In such case, the corporation will be entitled to use exception #1 for the period up to the end of its taxable year ending before the IPO.

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[57]1993 Conf. Rep. at 588.

[58]As discussed at II.D.2., the definition of an independent director committee is quite restrictive so that a privately held corporation will often lack such a committee.

[59]The corporation may wish to retain its SEC-financial reporting year to minimize any effect of the change on the IPO. *But see* Rev. Proc. 92-13 *supra* (requiring conformity between financial accounting year and tax year as a condition to its safe harbor allowing a change of tax year without IRS consent).

IV. Application to a Merger or Acquisition

The application of the $1 million deduction limitation where a purchaser ("P") acquires a target ("T") raises a number of issues, several of the more interesting of which are discussed below. For purposes of this part of the article, we assume that both P and T are calendar year corporations, that P acquires 100 percent of T's stock on July 1, and that P and T file a consolidated return after the acquisition.

A. Publicly Held T

Where P acquires a publicly held T, T will have a short pre-acquisition taxable year ending on the acquisition date.[60] However, T will still be entitled to a full $1 million per employee limitation on deductible compensation that does not otherwise qualify for an exception.[61] Section 162(m) does not contain any rule annualizing the $1 million deduction limitation for short taxable years.[62]

A more interesting question is whether T has any covered employees (other than its year-end CEO) for its last separate taxable year. This is particularly important where T has large acquisition-related compensation expenses that would be deductible absent section 162(m), e.g., change-in-control payments; payments to cash out stock options, phantom stock, deferred compensation, or bonus rights; accelerated vesting of restricted stock; or other acquisition-related bonuses ("acquisition-related compensation").[63]

T will not be required to file a directors proxy after its July 1 acquisition by P because T's old public shareholders will never again elect T directors after the acquisition.[64] As a result, the compensation of T's executive officers for T's last (short) separate taxable year will not be disclosed to shareholders in a directors proxy. Thus, it appears that only T's CEO will be treated as a covered employee for T's last short taxable year (since the year-end CEO is a covered employee without reference to the SEC disclosure rules). T's four highest compensated officers who would have been disclosed in a directors proxy statement if T had remained public are apparently not covered employees for T's last (short) separate taxable year because their total compensation for such year is not disclosed in a directors proxy.

Although T may be required to deliver a deal proxy under the 1934 act if T's shareholders are entitled to vote on the acquisition by P (e.g., because T is merging with P or a P subsidiary or selling its assets to P or a P subsidiary),[65] T's officers other than T's year-end CEO should still not be covered employees for T's last (short) separate taxable year. The deal proxy will disclose the compensation paid by T in its last completed fiscal year (i.e., not the year in which the proxy is being prepared, but the prior completed year) to those of T's executive officers who will, after the acquisition, be executive officers of P (within the meaning of the directors proxy rules). The deal proxy may also disclose special compensation paid as part of the transaction (although not in the usual compensation table). But the deal proxy will not disclose the "total compensation" of T's executive officers for the short taxable year in which the proxy is being prepared.

T may make some other filings with the SEC that disclose officer compensation.[66] However, these filings are not required to be sent to T's shareholders and, as a result, these filings should not cause any of T's officers to be treated as covered employees.

B. Publicly Held P's Covered Employees

An old T executive will be a section 162(m) covered employee *after* the acquisition only if he becomes a P covered employee, even if he was among T's covered employees prior to the acquisition (or would have been if T had been publicly held).

As noted above, if T is a P subsidiary after the acquisition (or has merged into a P subsidiary in a forward subsidiary merger) and the executive remains an employee of T (or the P subsidiary into which T merged) and does not also become a P employee, it appears that the executive is not a covered employee of P, even if the executive's compensation must be disclosed in P's directors proxy statement.[67]

Where a T executive becomes a P employee after the acquisition, it appears that compensation paid to the executive by T prior to the acquisition is generally not counted in determining whether the executive is required to be reported in P's directors proxy statement. The SEC is understood to have an internal unpublished position that only compensation paid by P (or by T while T was a P subsidiary) is counted in determining whether an executive is among P's four most highly compensated officers for purposes of disclosure in P's directors proxy.

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[60]*See* prop. reg. section 1.1502-76(b)(1). The proposed regulation, when finalized, will end the uncertainty under current law as to whether T joins the P consolidated group at the beginning or end of the acquisition day. *See*, Ginsburg & Levin, *Mergers, Acquisitions and Leveraged Buyouts*, Para. 209.03.

If P acquires T stock and P and T do not file a consolidated return, T's taxable year will not end.

[61]If T makes nondeductible golden parachute payments to its covered executives, the $1 million deduction limitation will be reduced as described in II.A. above.

[62]In contrast, the code often adjusts limits, brackets, thresholds and the like to reflect short taxable years. *See*, e.g., section 448(c)(3) (annualizing gross receipts for a short taxable year in determining whether the taxpayer can use the cash method of accounting); section 443 (setting out modifications to be used in filing a return for a short taxable year).

[63]Of course, T must carefully consider whether the golden parachute rules of section 280G would limit T's deduction for such payments.

[64]T may be required to file a form notifying the SEC that it is no longer required to file reports under the 1934 act.

[65]This 1934 act deal proxy may be part of an S-4 registration statement (under the 1933 act) delivered to T shareholders if P securities are issued in the acquisition.

[66]For example, Forms 10-K may be filed with the SEC. *See* footnote 14.

[67]*See* II.C.2. above.

We further understand that the SEC may be somewhat reluctant to apply this bright-line approach to acquisition-related compensation paid by T immediately before the acquisition. Even if the SEC were to assert that such compensation should be treated as paid by P (or on behalf of T *after* it became a P subsidiary), there appears to be a good argument that such compensation may be excluded from consideration in determining whether the executive is among the four most highly compensated P executives, on the ground that it is "unusually large . . . compensation . . . that is not part of a recurring arrangement and is unlikely to continue."[68]

C. P's Assumption of T's Arrangements

Where P assumes a T grandfathered compensation arrangement (i.e., a written binding T contract entered into on or before February 17, 1993, and not materially modified thereafter) in an acquisition, qualification for continuing grandfather protection after the acquisition will be lost if the assumption involves a material modification.[69] Such an assumption should not be treated as a material modification, unless the terms of the compensation agreement (other than the identity of the party obligated to pay the compensation) are materially modified in connection with the assumption. The authors urge the IRS to issue guidance to this effect.

Grandfather protection will be lost if the assumption involves a material modification.

A question also arises as to whether the substitution of a P stock option for a grandfathered T stock option would be considered a material modification. The authors believe that the standards of section 424(a) and (h) should be applied in determining whether a material modification has occurred (e.g., there would be no modification if the substituted P option had a spread that was not greater than the assumed T option and the executive was given no new benefits under the P option). However, IRS guidance would be desirable.

There are greater technical problems where an old T option is not grandfathered, but, when issued by T, such option qualified for the performance-based-compensation exception. Here the question is not whether a grandfathered arrangement has been materially modified but rather whether the new option qualifies for the performance-based-compensation exception. In this case, issuance of a new P option would not qualify for the performance-based-compensation exception if it is in the money (as is likely) at the time of the assumption and the assumption is viewed as a new issuance.[70] Again the authors believe that the IRS should allow a P option issued by P in an assumption of a T option to continue to qualify for the performance-based-compensation exception (on the technical ground that there is no new issuance) if (i) the T option qualified for such exception when issued and (ii) the assumption would qualify under the principles of section 424(a) and (h).

A number of other similar issues may arise when P assumes a T compensation arrangement or substitutes P stock for T stock in an arrangement other than an option.

D. Modifications to P's Arrangements

P may in certain cases wish to modify the performance goals contained in an outstanding compensation award where P undergoes a material change in its business (e.g., the disposition or acquisition of a division). Where this modification is discretionary with P (e.g., where the award says that the board may rather than shall appropriately adjust the performance goals after certain events), there is risk the IRS may take the position that such a discretionary modification causes the performance-based-compensation exception to be lost, on the ground that an objective performance goal cannot involve post-grant discretion.[71] Indeed, the mere possibility of such a change could give rise to such an IRS argument, even where it is never exercised.

The authors believe that the IRS should allow corporation to revise performance goals in this situation without the loss of the performance-based-compensation exception, as long as the revision does not materially increase the value of the arrangement to the executive.[72]

V. Conclusion

The authors believe that section 162(m) is an expression of political and social engineering and is in no way an expression of sound tax policy. As such, section 162(m) deserves quick repeal (which, unfortunately, it is not likely to receive).

The authors believe that section 162(m) is an expression of political and social engineering and is in no way an expression of sound tax policy.

It is not clear whether many corporations will consider it worthwhile to change compensation practices in order to preserve the compensation deduction for amounts paid to their top five executives in excess of $1 million per executive per year. On the other hand, even where the value of the lost deductions is not material to the corporation's finances, a public corporation may find it embarrassing to report that the compensation of its top executives is not fully deductible.

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[68]*See* SEC Regulation S-K, Instruction 3 to Item 402.

[69]We assume in this discussion that the T executive whose compensation arrangement is being assumed by P is a covered employee of P after the acquisition.

[70]There may be other technical issues. For example, the P option may not have been approved by P shareholders.

[71]Of course if the terms of the revised arrangement would qualify on its own as a new award, there would be no such problem. However, if the corporation wanted to preserve an in-the-money element present at the time of the modification, the revised award would not qualify on its own.

[72]*Cf.* section 424(a) and (h) discussed in C above.