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TAX ANALYSTS

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

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

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Section 162(m) places a $1 million limit on the deduction that a publicly held corporation may take for compensation to a top executive, including not only salary and bonuses, but also the spread in NQOs and other types of noncash compensation. In this article, Levin, Javaras, and Welke analyze and critique section 162(m) and the December 1993 proposed regulations and offer a number of suggestions for clarifying and improving the proposed regulations.

The authors describe seven important statutory and regulatory exceptions to the deduction limit. The most important exceptions are (1) for certain preestablished, objective, nondiscretionary, performance-based compensation approved by an independent board of directors committee and shareholders, (2) for compensation to an executive who is not one of the top five executives in the taxable year that the compensation deduction is otherwise *allowable,* and (3) for compensation from a corporation that is not publicly held when the compensation is deductible. The authors also describe several important transitional rules under the proposed regulations that modify and postpone certain complex and burdensome aspects of the proposed regulations.

While the proposed regulations take a reasonable (and occasionally even protaxpayer) position on many issues, the authors review several key issues where the proposed regulations are terribly ambiguous, harsh, or unworkable.

Finally, the authors criticize section 162(m) as an unwise exercise in political and social engineering and an embodiment of manifestly unsound tax policy: (a) imposing a compensation deduction limit on remuneration to a corporate executive but not on remuneration to (e.g.) an athlete or an entertainer, (b) imposing a deduction limit on executive compensation but not on advertising, research, marketing, or other expenditures, (c) creating a burgeoning time and cost drain on U.S. industry that is counter to our important national goal of increasing productivity and competitiveness, and (d) where a corporation's financial results take an unexpected turn, inevitably producing irrational results for many executives through rigid and unalterable bonus formulas adopted a year or more in advance.

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I. Introduction

The 1993 Tax Act added to the code a controversial provision, section 162(m), disallowing a corporation's federal income tax deduction for compensation to certain executives in excess of $1 million during a corporate taxable year. On December 20, 1993, the Internal Revenue Service published prop. reg. section 1.162-27 interpreting section 162(m) and adding a number of important transitional rules.[1]

A privately held corporation will generally not have to worry about section 162(m) until it goes public.

The $1 million deduction limit covers all types of compensation, including cash, property, and the spread on the exercise of options. However, there are a series of important exceptions, including:

- compensation paid by a privately held corporation,
- compensation paid by a publicly held corporation under a plan or agreement that existed before the corporation was publicly held,
- compensation paid to an executive other than one of the corporation's top five officers,
- performance-based compensation that is keyed to a preestablished, objective, nondiscretionary formula and also meets certain shareholder and outside director approval requirements,
- compensation covered by a pre-February 18, 1993, binding contract that has not been materially modified, 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 current salary and discretionary (nonformula) bonuses do not exceed $1 million in any year, and any compensation in excess of $1 million either (1) consists of formula performance-based bonuses, stock appreciation rights (SARs), restricted stock, or stock options structured to comply with the requirements of the performance-based-compensation exception or (2) is deferred to a time when the recipient is no longer one of the corporation's top five officers.

A publicly held corporation may have to disclose its choice to shareholders; as part of the SEC's November 29, 1993, amendments to the proxy disclosure rules,[2] the SEC announced that a corporation must disclose in its proxy statement its "policy with respect to qualifying compensation paid to its executive officers for deductibility under Section 162(m)."[3]

In contrast, if the approach of the proposed regulations is continued in the final regulations, a privately held corporation will generally not have to worry about section 162(m) until it goes public. Compensation deducted while the corporation is private is not subject to the $1 million deduction limit, and, under the proposed regulations, compensation subsequently paid pursuant to a plan or agreement adopted when the corporation was private is generally not subject to the $1 million deduction limit even though payable and deductible after the corporation goes public if disclosed in the IPO prospectus.

Part II of the article outlines the $1 million deduction limit, the complex statutory and regulatory exceptions to the deduction limit, and a number of uncertainties and pitfalls. Part III discusses the important transitional rules under the proposed regulations that postpone the full application of several burdensome aspects of section 162(m) as interpreted by the proposed regulations. Part IV discusses certain special issues in the application of section 162(m) to publicly traded partnerships and the interaction between section 83(b) and section 162(m). Part V offers our conclusions.

II. The Deduction Limit and Exceptions

A. Basic Deduction Limit

No corporation can deduct more than $1 million per executive per year for compensation to an executive, unless one of the seven exceptions described in II.B. through II.H. below applies. Section 162(m) does not eliminate the requirement that, to be deductible, compensation must qualify as "a reasonable allowance for salaries or other compensation for personal services actually rendered."[4] Thus, even if compensation meets one of the exceptions to the $1 million deduction limit, the compensation is still deductible only to the extent "reasonable."

No corporation can deduct more than $1 million per executive per year for compensation to an executive, unless one of the seven exceptions applies.

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 purposes of section 162(m) in the corpora-

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[1]This article revises and updates the authors' prior article on this topic, published in the October 4, 1993, issue of *Tax Notes* (p. 95), which was written before release of the proposed regulations.

[2]The amendments were released to the public on November 22, 1993, and were published in the *Federal Register* and made effective on November 29, 1993.

[3]58 *Fed. Reg.* 63,010, 63,011 (1993).

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

tion's taxable year in which such compensation would otherwise be deductible.

- The spread on exercise of 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.[5]
- Restricted stock (i.e., stock subject to vesting[6]) is generally taken into account (1) 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 (2) 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 limit does not cover compensation that is in the form of (1) contributions to or payments from qualified retirement plans or (2) nontaxable fringe benefits.[7]

The $1 million deduction limit is reduced by the amount of any nondeductible golden parachute payments the corporation makes to the executive in the same taxable year.[8] This unwarranted statutory provision unfairly penalizes a corporation twice for excess golden parachute payments and, in the authors' opinion, should be repealed. The proposed regulations, however, merely reiterate this statutory rule without explanation or amelioration.[9]

B. Exception #1: Privately Held Corporation

The $1 million deduction limit does not cover compensation paid by a privately held corporation.[10]

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).[11] A corporation thus is privately held as long as it (1) has no class of common equity securities traded on a national securities exchange and (2) 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).[12] A corporation is not publicly held if registration of its equity securities is voluntary, e.g., "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."[13]

> ***Whether a corporation is publicly held or privately held is determined solely by its status on the last day of the corporation's taxable year.***

The proposed regulations state that whether a corporation is publicly held or privately held is determined solely by its status on the last day of the corporation's taxable year.[14] A publicly held corporation that ceases to be public before the end of a taxable year is not subject to the $1 million deduction limit for any part of the taxable year. Conversely, a corporation that goes public in the middle of a taxable year is treated as publicly held for the entire year and is subject to the $1 million deduction limit for the entire year. However, the effect of this rule is mitigated by Exception #2 for plans or agreements entered into while a corporation was privately held (described immediately below).

C. Exception #2: Adoption of Plan or Agreement by Privately Held Corporation

Under the proposed regulations, the $1 million deduction limit does not apply to compensation paid under a "plan or agreement" that "existed" while the corporation was privately held, even if the compensation is paid and deductible while the corporation is publicly held, as long as the plan or agreement was disclosed in the corporation's initial public offering (IPO) prospectus in accordance with all applicable se-

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[5]*See* section 404(a)(5). The law is unclear whether payments of interest in connection with deferred compensation are treated as compensation. If such interest payments are not compensation, they would not be subject to the $1 million deduction limit. A deferred compensation plan often provides that deferred compensation accrues "interest" during the period between the time the compensation is earned and the time the compensation is paid. The Ninth Circuit recently held that the corporation may deduct this additional amount as interest (as it accrues) rather than as compensation (generally as it is paid under section 404(a)(5)). *Albertson's, Inc. v. Commissioner*, 12 F.3d 1529 (9th Cir. 1993). Under the Ninth Circuit's reasoning, this "interest" would not be compensation and its deduction would not be subject to section 162(m). The result in the *Albertson's* case has been criticized by many commentators and a bill to overturn the case has been introduced in Congress by Senate Finance Committee member David Pryor. At the government's request, the Ninth Circuit has granted a rehearing in the case.

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

[7]Section 162(m)(4)(E); prop. reg. section 1.162-27(c)(3)(ii)(A), as corrected by IRS release dated February 3, 1994. The error corrected by the February release would have effectively repealed section 162(m) by exempting from the $1 million deduction limit all compensation in excess of the FICA wage base ($60,600 for 1994). Announcement 94-30, 1994-8 I.R.B. 16.

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

[9]Prop. reg. section 1.162-27(g).

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

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

[12]"Publicly held" and "public" are used in this article to describe a corporation that is required to be registered 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 required to be registered under section 12 of the 1934 act and which may, therefore, rely on Exception #1.

[13]Conf. rep. no. 213, 103d Cong., 1st Sess. 585 (1993) ("1993 Conf. Rep."); *see also* prop. reg. section 1.162-27(c)(1)(i).

[14]Prop. reg. section 1.162-27(c)(1)(i).

curities laws.[15] The exception ceases to apply, however, if the plan or agreement is "materially modified" after the IPO.[16]

This welcome exception for pre-IPO arrangements is surprisingly broad. It would exempt from the $1 million deduction limit:

- compensation paid under a plan or agreement that is not performance based,
- compensation paid under a post-IPO award made under a pre-IPO plan allowing awards to be made many years after the IPO (or even indefinitely),[17] and
- compensation paid under a post-IPO award made under a pre-IPO plan even though the corporation is not legally required to make any awards under the plan.

In this latter respect, the exception for pre-IPO arrangements is much broader than the grandfather rule available to publicly held corporations for pre-February 18, 1993, binding contracts (discussed in II.F. below).

> ***The exception for pre-IPO arrangements is much broader than the grandfather rule for pre-February 18, 1993, binding contracts.***

It is not entirely clear exactly what constitutes a "plan or agreement" for purposes of applying this exception. The preamble to the regulations refers to "plans or arrangements" in discussing the exception, suggesting a broad scope.[18] It appears possible that a "plan or agreement" or "plans or arrangements" could encompass a corporation's consistent practice of paying salaries and bonuses in excess of the $1 million deduction limit, provided that adequate disclosure is made in the IPO prospectus, and even may extend to payments of compensation to the successors of the executives in place at the time of the IPO.

[15]Prop. reg. section 1.162-27(f).

[16]*Id.* For a discussion of "materially modified," *see* II.F.2. Although not specifically stated in the regulations, if a plan or agreement is materially modified and loses the protection of Exception #2, the Exception should continue to apply to (1) any compensation paid before the modification and (2) an award made under a plan prior to the modification (regardless of when the compensation attributable to the award is paid and deductible) so long as the award itself is not materially modified. The proposed regulations imply that this is the result, stating that the Exception is lost "to the extent that a plan or agreement is materially modified." It would be helpful if the final regulations made this more explicit.

[17]The Tax Section of the New York State Bar Association has proposed that this exception be limited to awards made during the 5-year period after a corporation's IPO. *See* Tax Section, New York State Bar Association, "Comments on Proposed Regulations Under Section 162(m) — The $1 Million Limitation on Deductible Compensation," (Mar. 4, 1994), *94 TNT 48-29* (Mar. 11, 1994).

[18]58 *Fed. Reg.* 66,310, 66,311 (1993).

The wording of this exception creates some confusion. The proposed regulations state that:

> In the case of a corporation that was not publicly held for the entire taxable year, the [$1 million] deduction limit . . . does not apply to any compensation plan or agreement that existed during the period in which the corporation was not publicly held.[19]

The reference to a "corporation . . . not publicly held for the entire year" could imply that the exception applies only to the year in which the corporation goes public, leaving the corporation fully subject to section 162(m) in subsequent years during which it is publicly held for the entire year. However, the authors believe that the exception is not intended to be limited to the IPO year. First, the regulatory preamble does not include a similar limitation, stating flatly that "section 162(m) will not apply to compensation paid under plans or arrangements that are in existence when a corporation becomes a publicly held corporation."[20] Second, the legislative history of section 162(m) states that where a privately held corporation goes public, the corporation will be deemed to satisfy the shareholder vote requirement of the performance-based-compensation exception (see II.E.3 below) with respect to its compensation plans if it discloses them in the IPO prospectus.[21] The only reasonable explanation for the proposed regulations' failure to include such a rule is that the broader exemption for a privately held corporation's plans or arrangements makes unnecessary the narrower exemption suggested by the legislative history. Finally, Treasury attorneys have indicated privately that Exception #2 is not intended to be limited to the IPO year.

The preamble to the proposed regulations does not state a rationale for this exception. However, the exception must be based on more than the mere fact that the new public shareholders may be regarded as having approved the existing arrangements because they purchased the stock after disclosure of the arrangements in the IPO prospectus.[22] The rationale is apparently that, where such items are disclosed to shareholders in the IPO prospectus, the new public shareholders take the existence of such arrangements into account in determining the amount they are willing to pay for the stock offered in the IPO and that, as a result, the pre-IPO shareholders (and not the new public shareholders) bear the cost of any excessive compensation arrangements.

If proposed regulations are finalized in their current form, Exception #2 will generally mean that a privately held corporation need not worry about the effects of

[19]Prop. reg. section 1.162-27(f).

[20]58 *Fed. Reg.* at 66,311.

[21]1993 Conf. Rep. at 588.

[22]If approval by public shareholders alone were enough to justify an exception to section 162(m), the exception for performance-based compensation (see Exception #4 below) would not be conditioned on meeting other requirements (e.g., a preestablished, objective, formula, performance goal).

section 162(m) while it is private, because any compensation paid in a year when it is private for the entire year qualifies for Exception #1 and any plan or agreement entered into while it is private (obviously including any compensation paid in the IPO year but before the IPO) qualifies for Exception #2 when it later goes public in an IPO (as long as proper disclosure is made).[23] In general, the only reason that a privately held corporation may need to worry about section 162(m) is that (1) there are cases in which a corporation may become public within the meaning of section 162(m) and potentially not qualify for Exception #2 (see II.C.1. and II.C.2. immediately below) and (2) it may be beneficial for the corporation to adopt certain plans before it goes public in an IPO in order to obtain the benefit of this Exception #2 (see II.C.3. below).

1. Subsidiary of a public company. It is not clear whether Exception #2 applies to a corporation that was, before going public, a subsidiary of a publicly held corporation. Although such a subsidiary had no stock that was publicly traded or required to be registered prior to its own IPO, the proposed regulations state that a "publicly held corporation includes an affiliated group of corporations."[24] Thus, where the subsidiary is part of a publicly held parent's affiliated group prior to the subsidiary's IPO, the subsidiary is apparently considered to be publicly held prior to its IPO, in which case it could not rely on Exception #2. The authors believe that the rationale behind Exception #2 applies equally well to an IPO of a privately held subsidiary of a publicly held parent and urge that the final regulations clarify that such a subsidiary may rely on Exception #2.

Exception #2 will generally mean that a privately held corporation need not worry about the effects of section 162(m) while it is private.

2. Corporation becoming public without an IPO. Exception #2 seems to assume that all corporations become public through an IPO in which a prospectus is given to new shareholders disclosing existing compensation plans and agreements. However, it is possible for a corporation to become public within the meaning of the proposed regulations without an IPO and the accompanying prospectus. For example, if the number of shareholders of a privately held corporation with $5 million or more of assets increases to more than 500 (e.g., through unregistered primary or secondary sales of stock), the corporation must register and begin reporting under section 12 of the 1934 act and hence is publicly held within the meaning of section 162(m). Similarly, if a privately held corporation is acquired by a publicly held corporation, it becomes publicly held within the meaning of prop. reg. section 1.162-27(c)(1)(ii) (as a member of the publicly held acquiror's affiliated group). In either case, it appears that the former privately held corporation may not be entitled to rely on Exception #2 for its existing compensation plans and agreements because it has not issued stock in an IPO with a prospectus.

The authors believe that the final regulations should be amended to extend Exception #2 to these cases. Such a change would have the beneficial effect of removing any need for a privately held corporation to worry about section 162(m) prior to becoming public.

Where the privately held corporation is acquired by a publicly held corporation, the publicly held corporation (acting on behalf of its public shareholders) has knowledge of the privately held corporation's plans and agreements and has taken them into account in determining the price it is willing to pay to acquire the privately held corporation. Thus, the apparent rationale of Exception #2 seems satisfied (in that the shareholders of the privately held corporation will bear the cost of excessive compensation plans and agreements).

If a privately held corporation that is acquired by a publicly held corporation cannot rely on Exception #2, the privately held corporation should consider whether to take steps to allow it to recognize the deduction for outstanding compensation arrangements during a year in which the corporation is privately held (and thus may rely on Exception #1). For example, the privately held corporation may wish to cash out restricted stock and encourage its executives to exercise any outstanding options immediately prior to the acquisition.

3. Planning for an IPO. A corporation planning an IPO should adopt (before the IPO) any compensation plan or agreement the corporation wants to utilize after the IPO so that the plan or agreement can be disclosed in the IPO prospectus and qualify for Exception #2. There appears to be no requirement that any award be made under such a plan or agreement prior to the IPO in order to qualify for Exception #2.[25]

D. Exception #3: Noncovered Employee

The $1 million deduction limit does not apply to compensation paid to an executive who is not a

[23]Compensation deductible in the IPO year that is paid before the IPO does not qualify for Exception #1 (because the corporation is treated as publicly held for the entire year) but should qualify for Exception #2.

[24]Prop. reg. section 1.162-27(c)(1)(ii).

[25]There may be a technical issue if the plan or agreement is adopted in the same taxable year in which the IPO took place. The proposed regulations generally treat a corporation that is public on the last day of the taxable year as public for the entire taxable year. Hence, IRS may make the technical argument that where a corporation adopts a plan or agreement in the IPO year, the plan or agreement did not exist before the corporation was public (for tax purposes).

The authors do not believe that IRS intended this result. First, the proposed regulation's reference to a "corporation . . . not publicly held for the entire taxable year" indicates that the drafters, when they drafted Exception #2, were not focused on the rule that a corporation that is public on the last day of its taxable year is treated as public for the entire year. Second, the regulatory preamble refers to plans or arrangements "in existence when a corporation becomes a publicly held corporation," so that the test would be whether the plans or arrangements were "in existence" before the IPO, not before the IPO taxable year. 58 *Fed. Reg.* at 66,311. Finally, any other reading would conflict with the broad reading of Exception #2 given privately by Treasury attorneys.

"covered employee."[26] For this purpose, a "covered employee" means:

- the CEO, "or . . . an individual acting in such a capacity" "as of the close of the taxable year,"[27] plus
- 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]."[28]

Significantly, the proposed regulations state that a person who is not "employed on the last day of the taxable year" is not a covered employee.[29] As a result, if an executive leaves the corporation's employ before the last day of the corporation's taxable year, the $1 million deduction limit will not apply to any compensation paid to the executive in such year or in any year thereafter. This is true even if the executive's compensation is disclosed in the proxy statement as compensation paid to a former executive under the broader new SEC disclosure rules described in II.D.1. below.[30]

1. Coordination with the 1934 Securities Act. 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. Registration under the 1934 act requires a publicly held corporation to disclose the compensation of its CEO and certain other highly paid executive officers in its proxy statement issued to shareholders in connection with the election of directors as well as a vote on certain executive compensation arrangements.[31]

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

[27]Section 162(m)(3)(A).

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

[29]Prop. reg. section 1.162-27(c)(2) and (c)(6) (Example 1).

[30]Query whether a top executive who retires from a corporation before the end of the taxable year and who thereafter performs consulting services for the corporation is a covered employee. If the retired executive is merely an independent contractor, it would appear that he or she is not a covered employee since he or she is not an employee at all. (It would be helpful if final regulations clarified that an independent contractor is not a covered employee.) Even if the retired executive performs consulting services as an employee, he or she should not be a covered employee (as discussed below) if he or she does not, after his or her retirement, participate in policy making for the corporation (given that SEC rules require disclosure of executive compensation only for officers with policy-making duties).

[31]SEC Schedule 14A, Item 8; SEC Regulation S-K, Item 402(a)(3). Section 162(m) defines covered employee by reference to disclosure to shareholders (see section 162(m)(3)). The legislative history (*see* 1993 Conf. Rep. at 585) and, in general, the proposed regulations (*see* prop. reg. section 1.162-27(c)(2)(ii)) and regulatory preamble (*see* 58 *Fed. Reg.* at 66,311) refer only to a disclosure obligation, without explicitly stating whether disclosure to shareholders or some other disclosure (e.g., disclosure to the SEC) is meant. One example in the proposed regulations implies that shareholder disclosure is required. It reiterates the statutory reference to the 1934 act shareholder disclosure requirement. *See* prop. reg. section 1.162-27(c)(6) (Example 1).

(Footnote 31 continued in next column.)

As interpreted by the proposed regulations, section 162(m)'s definition of covered employee is based on SEC regulations in effect at the time section 162(m) was enacted (i.e., the SEC regulations in effect before the SEC regulatory amendment described below). Under these "old" SEC regulations, a corporation was required to disclose in its proxy statement the compensation of its CEO and four other highest compensated executive officers as of the end of the last completed fiscal year. Disclosure of an executive's compensation was not required if the executive left the corporation's employ before the end of the last completed fiscal year.[32]

> ***An executive would not be a covered employee if he or she retired or left the corporation's employ before the last day of the year.***

Effective November 29, 1993, the SEC amended its regulations governing disclosure of executive compensation, broadening the required disclosure to include the compensation of certain executives who left the corporation's employ during the year. Under these "new" regulations, the corporation must disclose the compensation of those executives covered by the "old" regulations plus the compensation of (1) any person who was CEO at any time during the year and (2) up to two executives who would have been among the four highest compensated non-CEO executives but for the fact that they left the corporation's employ prior to the end of the year.[33]

The proposed regulations do not utilize the "new" SEC regulations and effectively follow the "old" SEC rules, stating that a person who is not an officer "employed on the last day of the taxable year" is not a covered employee.[34] Thus, for example, an executive would not be a covered employee if he or she retired or left the corporation's employ before the last day of the year, even if he or she is listed in the corporation's proxy statement under the "new" SEC rules (because

This distinction could prove significant. A publicly held corporation is required to file with the SEC certain forms (e.g., Form 10-K) that do not have to be sent by the corporation to all shareholders. Any disclosure in these forms would arguably not be taken into account for section 162(m) purposes because such disclosure is not "required to be reported to shareholders."

Where a publicly held corporation files no proxy statement, the SEC requires the summary compensation table to be included in the corporation's Form 10-K filed with the SEC. Query whether disclosure on Form 10-K has the effect of a report to shareholders because the information is made available, although not sent, to them. The authors believe that a disclosure on Form 10-K is not a report to shareholders.

[32]SEC Regulation S-K, Item 402(a)(3), as in effect prior to November 29, 1993.

[33]*See* SEC Regulation S-K, Item 402(a)(2), as in effect since November 29, 1993.

[34]Prop. reg. section 1.162-27(c)(2) and (c)(6) (Example 1).

under the "new" SEC rules he or she would have been among the four highest compensated (non-CEO) officers had he or she not left the corporation's employ). Prior to the issuance of the proposed section 162(m) regulations, it appeared likely that such an executive would have been a covered employee under section 162(m) because his or her compensation was required to be reported to shareholders under the 1934 act.[35]

Where an individual ceases to be an executive officer of the publicly held corporation (i.e., ceases to have policy-making authority within the meaning of the SEC rules[36]) before the last day of the taxable year but remains an employee, the result is less clear. Apparently, the individual is not a covered employee, even if his or her compensation is disclosed in the publicly held corporation's proxy statement as a former CEO or a former executive officer under the "new" SEC rules. Under the proposed regulations, a covered employee is "any individual who, *on the last day of the taxable year,*" is the CEO or one of the four highest compensated officers whose compensation is required to be disclosed to shareholders in the corporation's proxy statement.[37] An individual who is not an officer (within the meaning of the SEC rules) on the last day of the taxable year may be disclosed in the corporation's proxy statement under the "new" SEC rules as a former CEO or as an individual who would have been one of the four highest compensated officers if he or she were still an officer. But in such case, the disclosure would not be made because the person was the year-end CEO or one of the four highest non-CEO officers on the last day of the taxable year and the individual should therefore not be classified as a covered employee under section 162(m).[38]

In determining the four highest compensated officers at year-end as well as the year-end CEO, the proposed regulations incorporate SEC reporting principles (not tax principles).

In determining the four highest compensated officers at year-end as well as the year-end CEO, section 162(m) and the proposed regulations incorporate SEC reporting principles (not tax principles).[39] 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.[40]

2. Employees of subsidiaries. Under SEC rules, compensation paid to an employee of a privately held subsidiary is clearly required to be disclosed in the publicly held parent's proxy statement where (1) the employee would, if he or she were an employee of the parent, be among the four highest compensated non-CEO officers, and (2) the employee is an officer of the subsidiary, and (3) the employee exercises policy-making authority with respect to the parent's business.[41] For SEC purposes, it appears that a subsidiary is any corporation controlled by the parent (in general, this would normally mean a corporation 50 percent or more of the voting power of which is owned by the parent, but in some cases control could exist where the parent owns less than 50 percent of the subsidiary by vote).

In contrast, the statutory language of section 162(m) seems expressly to limit the application of section 162(m) to employees of the publicly held parent (not including employees of subsidiaries). The statutory definition of covered employee refers to "any employee of the taxpayer"[42] where the "taxpayer" clearly refers back to the publicly held corporation mentioned in section 162(m)(1).[43] In spite of this statutory language, the proposed regulations take the questionable position that a publicly held corporation includes not only the corporation which is publicly held but also all members of its affiliated group as defined in section 1504(a) (without regard to section 1504(b)),[44] regardless of whether a consolidated return is filed.

Thus, where a publicly held corporation owns sufficient stock of a privately held subsidiary to satisfy both the 80-percent-by-value and the 80-percent-by-vote requirements of section 1504(a), the proposed regulations would treat an executive of the subsidiary as a covered employee if the executive's compensation is required to be disclosed in the publicly held parent's proxy statement for SEC purposes (generally where the

[35]*See* section 162(m)(3)(B).

[36]*See* SEC Rule 3b-7.

[37]Prop. reg. section 1.162-27(c)(2) (emphasis added).

[38]This view is supported by the regulatory preamble which indicates that a covered employee "must be employed as an executive officer on the last day of the taxable year." 58 Fed. Reg. at 66,311.

[39]Section 162(m)(3); prop. reg. section 1.162-27(c)(2)(ii).

[40]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 the corporation's tax year differs from its SEC-financial reporting year, the proposed regulations are flawed and ambiguous. They state that a covered employee 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])." Literally read, this requirement will never be met because there is no SEC reporting for the "taxable year." IRS's intent is not clear.

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

[42]Section 162(m)(3).

[43]In contrast, under the golden parachute rules of section 280G, the statute explicitly treats the members of an affiliated group as a single corporation and any officer of a member of the group as an officer of that single corporation. *See* section 280G(d)(5).

[44]Prop. reg. section 1.162-27(c)(1)(ii).

subsidiary executive exercises policy-making authority with respect to the parent's business and the executive is one of the four highest compensated year-end non-CEO officers so disclosed in the parent's proxy statement).

Where the publicly held parent's stock ownership in the privately held subsidiary does not meet both the 80-percent-by-value and 80-percent-by-vote tests, the subsidiary will not be treated as part of the publicly held corporation under the proposed regulations and hence an executive of the subsidiary would not be a covered employee. Even in that case, however, it is possible that the subsidiary executive's compensation could be disclosed in the parent's proxy statement, because, as discussed above, the SEC does not limit subsidiaries to those that meet section 1504's 80-80 test.

The definition of covered employee may leave some opportunities for aggressive taxpayers.

In those cases where a subsidiary is publicly held on its own (without regard to the affiliation rule of the proposed regulations), section 162(m) would independently apply to the publicly held subsidiary. Thus, the publicly held subsidiary would have its own covered employees whose compensation would be subject to the $1 million deduction limit.

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

This rule is particularly important 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 limit, the corporation may want to grant all or a portion of the compensation in the form of deferred compensation that 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.[45]

Conversely, a corporation may also find it desirable to structure compensation arrangements to fit the performance-based-compensation exception (Exception #4 below), even where the executive is not a covered employee when the arrangement is entered into, if there is any possibility that the executive may subsequently be a covered employee when the compensation becomes deductible.

4. Management corporation or partnership. The definition of covered employee may leave some opportunities for aggressive taxpayers.[46] For example, an executive could set up a wholly owned corporation that would employ the executive to perform services for the publicly held corporation. The publicly held corporation would pay compensation to the executive's corporation (but not to the executive). If the arrangement is respected, the publicly held corporation may be able to deduct the compensation without regard to the $1 million deduction limit on the ground that the executive's personal service corporation is not a covered employee, and the executive's corporation could deduct compensation it pays to the executive because it is not a publicly held corporation subject to section 162(m).[47]

[45]As noted above, the proposed regulations state that an executive is a covered employee only if employed as the corporation's CEO or as one of the corporation's four highest compensated officers (other than the CEO) on the last day of the corporation's taxable year. Prop. reg. section 1.162-27(c)(2) and (c)(6) (Example 1). As a result, if an executive retires or otherwise leaves the corporation's employ before the last day of the corporation's taxable year, the $1 million deduction limit will not apply to any compensation paid to the executive in that or a subsequent year.

[46]The techniques suggested in this section II.D.4. may raise collateral issues, e.g., an executive's eligibility for certain benefit plans may turn on whether the executive is an employee. These collateral issues should be examined if a corporation is contemplating the use of one or more of these techniques.

[47]Section 269 would not apply to this situation, because it applies only where a "person [here the executive] . . . acquire[s] . . . control of a corporation [here his or her personal service corporation] . . . and the principal purpose . . . is avoidance of Federal income tax by securing the benefit of a deduction . . . *which such person [here the executive] or corporation [here his or her personal service corporation]* would not otherwise enjoy" (emphasis added). In this case, the deduction is enjoyed by the publicly held corporation.

Personal service corporations have sometimes been upheld as a separate entity for tax purposes and in other cases disregarded. *Compare, e.g., Sargent v. Commissioner*, 929 F.2d 1252 (8th Cir. 1991) *with Johnson v. Commissioner*, 78 T.C. 882 (1982), *aff'd without opinion*, 734 F.2d 20 (9th Cir. 1984).

However, recent developments with respect to personal service corporations tend to focus on eliminating the tax benefits to the owners of the personal service corporation. *See, e.g.*, section 269A (eliminating some benefits obtained by owners of a personal service corporation); *Sargent*; *Johnson*. In contrast, under section 162(m), the benefits described in the text would flow to the publicly held corporation rather than to the executive-owner of the personal service corporation.

(Footnote 47 continued on next page.)

In this situation, there are at least three alternatives as to whom the corporation would disclose in its directors proxy statement as one of its most highly compensated officers: the executive's personal service corporation, the executive, or a third person (i.e., a different executive). The executive's personal service corporation cannot be a covered employee because it is not an individual.[48] Thus, if the publicly held corporation treats either the personal service corporation or a third person as the officer whose compensation was required to be disclosed in the proxy statement for SEC purposes,[49] neither the executive nor his personal service corporation would be a covered employee and hence the technique should work if the arrangement is respected.

If the corporation treats the executive as an officer whose compensation was subject to disclosure in the proxy statement, the result is somewhat less clear. While the executive would be a covered employee, the compensation paid by the publicly held corporation would not be paid to the covered employee. Thus, if the arrangement were respected, the technique might still avoid the $1 million deduction limit.

Under a second potential technique, a publicly held corporation could establish a 79-percent-owned subsidiary (i.e., a subsidiary that is not part of the publicly held parent's affiliated group) to employ and compensate top executives who would otherwise be covered employees of the publicly held parent.[50] The publicly held parent would make payments to the subsidiary for the management services of the top executives and the privately held subsidiary would pay a similar amount of compensation to the top executives. If this arrangement is respected, the subsidiary would not be treated as part of the publicly held parent under the proposed regulations (because it does not meet section 1504's 80-80 test) and, as a result, the executives would not be covered employees of the publicly held parent. The publicly held parent's payments to the subsidiary (and the subsidiary's payments to the executives) would apparently be deductible without regard to section 162(m). Because the privately held 79-percent-owned subsidiary would be controlled by the publicly held parent under SEC standards, the subsidiary officers would be listed in the parent's proxy statement (assuming they performed policy-making roles with respect to the parent's business). See II.D.2. above.

Although a payment to a personal service corporation is treated as a payment to an individual for purposes of the golden parachute rules, this treatment is based on a specific statutory provision in section 280G. *See* section 280G(d)(5); prop. reg. section 1.280G-1, Q&A 16. The lack of any similar statutory provision in section 162(m) may suggest that payments to a personal service corporation would be respected for purposes of section 162(m).

[48]*See* prop. reg. section 1.162-27(c)(2)(i).

[49]It seems unlikely, however, that the SEC rules would require, or even allow, a corporation to be treated as an officer in the proxy statement.

[50]Unlike the other two techniques, this second technique risks attack under section 269.

A third potential technique involves the creation of a partnership owned largely by the publicly held corporation that would employ one or more executives who would otherwise be covered employees if they were employed directly by the publicly held corporation. As in the case of the 79-percent subsidiary, the partnership would not be part of the publicly held corporation's affiliated group for tax purposes and hence would not be treated as part of the publicly held corporation under the proposed regulations. By contrast, where (as is likely with a 79-percent-owned partnership) the partnership is controlled by the publicly held corporation under SEC standards, the partnership's policy-makers would likely be listed as officers in the publicly held corporation's proxy statement. This arrangement is more risky from the tax standpoint than the use of a 79-percent subsidiary since the partnership's deductions for compensation paid to the executives would flow through onto the publicly held corporation's tax return with its character determined "as if such item were . . . incurred [by the publicly held corporation] in the same manner as incurred by the partnership."[51]

E. Exception #4: Performance-Based Compensation

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

- The compensation is payable solely on account of attaining one or more preestablished, nondiscretionary, objective, performance goals.
- The performance goal is determined by a compensation committee of the board of directors comprised solely of two or more outside directors.
- 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.
- Before the compensation is paid, the compensation committee certifies that the performance goals and any other material terms were satisfied.

II.E.1. through II.E.4. below discuss each of these requirements in greater detail.

1. Nondiscretionary performance goal. The first requirement of the performance-based-compensation exception is that the compensation be payable solely on account of attaining one or more preestablished nondiscretionary objective performance goals.[52] According to the proposed regulations, a "preestablished performance goal must state, in terms of an objective formula or standard, the method for computing the amount of compensation payable to the employee if the goal is attained."[53] For this purpose, a formula or standard is objective "if a third party having knowledge of the

[51]Section 702(b).

[52]Section 162(m)(4)(C). *See also* prop. reg. section 1.162-27(e)(2).

[53]Prop. reg. section 1.162-27(e)(2)(ii). *See also* 1993 Conf. Rep. at 586.

relevant performance results could calculate the amount to be paid to the employee."[54]

Performance goals may be "based on one or more business criteria that apply to the individual, a business unit, or the corporation as a whole . . . includ[ing], for example, stock price, market share, sales, earnings per share, return on equity, or costs."[55] A formula goal will not qualify if it relates solely to (1) an outside standard (e.g., the S&P 500 Index reaching a specified level)[56] or (2) the executive's continued employment (e.g., requiring at least five years of continuous employment).[57]

The proposed regulations clarify that a "performance goal need not . . . be based upon an increase or positive result under a business criterion and could include, for example, maintaining the status quo or limiting economic losses (measured, in each case, by reference to a specific business criteria)."[58]

Performance goals, however, need not be connected to any minimum length of service by the executive, as long as the goal itself is performance related.

The performance goals, however, need not be connected to any minimum length of *service* by the executive, as long as the goal itself is performance related. Thus, an award may be performance-based even if an executive who retires before the goal is either met or not (e.g., an executive who retires in the second year of a three-year incentive bonus program) is entitled to receive compensation if the goal is satisfied after his retirement. 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.

a. Substantially uncertain and preestablished. There is a risk that an objective performance goal could be disregarded as a sham for purposes of the performance-based-compensation exception, 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. The proposed regulations deal with this concern in two ways.

First, the proposed regulations require that a performance goal be established while the "outcome is substantially uncertain." This standard unfortunately appears to invite IRS agents to assert, with the benefit of hindsight, that a performance goal was too easy to attain. The proposed regulations contain only one example illustrating a purported performance goal that was not substantially uncertain when established: an executive was granted compensation contingent on settlement of certain litigation, but, at the time of the grant, the other party to the litigation had already "informally indicated . . . a willingness to settle" on the terms set forth in the grant.[59] The authors recommend that final regulations add examples to make clear that a performance goal is satisfactory as long as there is some uncertainty about attaining the goal, and that IRS agents are not to examine, with hindsight, the degree of difficulty inherent in a legitimate performance goal.

The proposed regulations are silent regarding application of the substantially-uncertain-outcome standard to an arrangement where at least a portion of the potential compensation is relatively likely to be earned, for example, a plan calling for a bonus to one or more executives equal to a percentage of next year's profits (either a specified uniform percentage of profits or possibly a percentage which escalates as the level of profits escalates), where it is likely that the corporation will have at least some profits.[60] There is some risk IRS might take the position that (1) in light of the prevailing economic climate and the corporation's past history, the corporation is substantially certain to earn at least some profit the next year so that the executive's right to a bonus is partially in the money and (2) the proposed regulations (as drafted) do not permit an award to be bifurcated into an in-the-money portion and a not-in-the-money portion, so that the entire plan is disqualified. Such a result would be particularly unfortunate. The authors believe that the likelihood a corporation engaged in business inthe United States today will have profits for its coming year is never so certain as to flunk the substantially-uncertain-outcome test (except perhaps in the highly unusual situation where the corporation's assets consist primarily of unleveraged blue chip bonds or leases). Hence, the authors believe that the final regulations should (1) make clear that except in this unusual case of "locked-in" profitability a bonus based on profits is substantially uncertain[61] and (2) be revised to allow bifurcation in the unusual case where some portion of the corporation's profits are substantially certain.[62]

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[54]Prop. reg. section 1.162-27(e)(2)(ii).

[55]Prop. reg. section 1.162-27(e)(2)(i).

[56]The corporation's own performance on a particular business criterion can, of course, be measured against an outside standard. For example, a performance goal could state that a bonus would be paid to executives if the total shareholder return on the corporation's stock exceeded the total return on the S&P 500 index.

[57]Prop. reg. section 1.162-27(e)(2)(i).

[58]*Id.*

[59]Prop. reg. section 1.162-27(e)(2)(vii) (Example 2).

[60]Some comments to Treasury have argued that such an arrangement should be performance based by analogy to Exception #7 for commissions (see II.H. below), which applies even if commissions are reasonably certain to be earned. This analogy is not compelling because commissions must be based on individual (rather than corporate or business unit) performance.

[61]Where an executive is entitled to a bonus based on a percentage of the corporation's sales (rather than profits), qualification as performance-based compensation may be more difficult. Because the corporation is likely to have sales (even where it may not have profits), the award is likely to be viewed as partially in-the-money and hence not wholly performance-based unless the award also incorporates a reasonable sales threshold before a bonus is earned.

[62]*See* New York State Bar Association, "Comments on Proposed Regulations Under Section 162(m) — The $1 Million Limitation on Deductible Compensation," (Mar. 4, 1994), *94 TNT 48-29* (Mar. 11, 1994).

Second, the proposed regulations require that the performance goal be "established in writing by the compensation committee prior to the commencement of the services to which the performance goal relates."[63] Thus, according to the regulatory preamble, "if a bonus will be paid on the basis of an increase in sales during 1995, this performance goal would have to be established prior to 1995."[64]

There is no requirement in the statute that a goal be established before commencement of the service period.

The authors believe the requirement that the outcome of a performance goal be "substantially uncertain" at the time of a grant prevents any abuse and obviates any need for a further requirement that the performance goal be set prior to the time the executive begins the services. Where a calendar year corporation wishes to establish a goal for the entire calendar year, there is nothing wrong with establishing the goal in January or even later, so long as the outcome is substantially uncertain when the goal is set. A corporation setting a performance goal for, e.g., calendar year 1995 legitimately will want to know the financial results for the prior year 1994. In general, such results are not available until one or two months into the succeeding year.

There is no requirement in the statute that a goal be established before commencement of the service period. While the legislative history of section 162(m) does refer to a "preestablished objective performance formula or standard,"[65] this lone reference to "preestablished" hardly mandates that goals be set before the *start* of the service period.

For performance goals established in 1994, Notice 94-2[66] issued December 21, 1993, relaxes the proposed regulations' requirement that a performance goal be determined before the executive commences the service where:

- the compensation committee establishes the goal before April 1, 1994,
- the outcome of the goal is substantially uncertain at the time the goal is established,
- the period of service to which the goal relates does not begin before January 1, 1994, and
- the period of service is scheduled to continue for at least nine months.[67]

On the assumption that IRS believes it should require explicitly that a performance goal be set "early," the authors recommend that the approach of Notice 94-2 be extended to all years.[68] The requirement that a goal be set near the beginning of the service period clearly satisfies any requirement that the goal be "preestablished."

If IRS retains this unnecessary rule, it will be an inconvenience and a trap for the unwary. A corporation can generally comply with it by changing the formal terms of the grant. A calendar year corporation establishing a goal late in January could phrase the goal in terms of the corporation's 11-month performance from February through December.

b. Discretion. 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."[69] The proposed regulations confirm that there must be no discretionary right to *increase* compensation[70] but permit the compensation committee to retain unfettered discretion to *reduce or eliminate* the amount payable upon attainment of the goal.[71]

There are often 'subjective' determinations that must be made in the calculation of a business criterion used to set a performance goal.

The discretion to reduce may in fact be the practical equivalent of discretion to increase. For example, assume that a publicly held corporation (through its compensation committee) grants an employee the right to receive a $1 million bonus if a performance goal is met, but also authorizes the compensation committee to reduce the bonus to an amount not less than $500,000. The arrangement resembles the grant of an award entitling the employee to receive a $500,000 bonus if the goal is attained, coupled with the prohibited discretion to increase the bonus. While such an arrangement is

[63]Prop. reg. section 1.162-27(e)(2)(i).

[64]58 *Fed. Reg.* at 66,311.

[65]1993 Conf. Rep. at 586.

[66]1994-2 I.R.B. 25.

[67]It is unclear whether the latter requirement mandates that the service period run nine months from the beginning of the service period or from the date the performance goal is established.

[68]It is particularly important that the relaxed approach of Notice 94-2 be extended to multiyear goals adopted for periods beginning before 1994. There is no justification for applying the "preestablished" rule to pre-1994 multiyear goals set before taxpayers knew IRS might attempt to impose this harsh and unanticipated rule.

[69]1993 Conf. Rep. at 586. *See also* prop. reg. section 1.162-27(e)(2)(ii).

[70]Indeed, the language of the proposed regulations could be read to suggest that the grant must explicitly preclude any discretion to increase the compensation. *See* prop. reg. section 1.162-27(e)(2)(iii)(A). In the authors' view, it should be sufficient that the formula result in an objective amount without any resort to discretion. There should be no further need to state explicitly that there is no discretion to increase the amount.

[71]Under the proposed regulations, it is apparently only the compensation committee that can have the discretion to reduce awards. *See* prop. reg. section 1.162-27(e)(2)(iii)(A). Thus, such discretion could not be given to the board of directors as a whole or to the CEO.

permitted by the literal words of the proposed regulations, query whether there are circumstances in which IRS might seek to treat the discretion to reduce as a prohibited discretion to increase (e.g., where the corporation had stated that it intended to exercise its discretion to reduce the award to $500,000 unless the executive's performance was particularly deserving in the committee's discretion). Moreover, a publicly held corporation may in fact be reluctant to use the "discretion-to-reduce" technique because the corporation must disclose the high potential bonus number to shareholders (under the shareholder approval requirements described in II.E.3. below).

There are often "subjective" determinations that must be made in the calculation of a business criterion used to set a performance goal. For example, where a corporation grants a performance-based award to a covered employee based on achieving an earnings per share (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. In general, such subjective judgments in the calculation of EPS should not be viewed as a prohibited discretion to increase an award since EPS is determined for substantial noncompensatory business purposes (e.g., for reports to shareholders, lenders, securities analysts, etc.). Similarly, the authors believe that the final regulations should not preclude other types of subjective determinations in the calculation of a business criterion where the business criterion is determined for substantial noncompensatory business purposes.

A more serious issue regarding discretion arises where a publicly held corporation wishes to eliminate the effect of unexpected events on the determination of a business criterion. For example, the corporation may wish to calculate EPS for purposes of an incentive plan without regard to the effects of material unexpected events. Where the potential unexpected events are of a type specified with particularity in advance (e.g., a casualty loss arising out of an act of God with damage in excess of $1 million or a product liability judgment in excess of $1 million), there should generally be no problem. The exclusion of specified, unexpected events is merely an additional objective element in an overall objective formula (a third party with the relevant information would be able to do the calculation) and does not give rise to any prohibited discretion. Where the corporation wishes, however, to exclude the effect of unexpected events without specifying the types of events in advance (or wishes to retain *discretion* to exclude or not exclude specified events), there is a strong risk that the corporation will be found to have retained discretion, hence barring reliance on the performance-based-compensation exception (whether or not such an unexpected event occurs).

A formula should not be disqualified where discretion is retained to adjust the formula if the result will be a reduction of the award. Similarly, the authors believe that a formula should not be disqualified where the formula mandates the exclusion of "extraordinary items" as determined under GAAP, since the use of professional judgment in applying GAAP should not be viewed as the equivalent of discretion.

c. Aggregation rules. If an executive receives a tandem award (i.e., an arrangement allowing the executive to choose one, but only one, of two alternative awards), it appears that both alternative 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 one, but not both, of the following: (1) a $2 million bonus in any event or (2) 100,000 shares of the corporation's stock if an objective performance goal is met and the executive so elects.

> ***If an executive receives a tandem award, both alternative awards must qualify for the performance-based-compensation exception if either is to qualify.***

Such an arrangement should be treated as one award for purposes of the $1 million deduction limit. Because it is in-the-money at grant (i.e., because the executive is guaranteed at least $2 million), the entire award should 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 stock.

The proposed regulations are grandly ambiguous on the important issue of when two awards will be combined for purposes of determining whether an arrangement (1) is in-the-money at grant or (2) is otherwise noncontingent in whole or in part:

- In a burst of pro-integration enthusiasm, the proposed regulations state that "[a]ll plans, arrangements, or agreements that provide for compensation to the employee will be taken into account" for these purposes.[72]
- On the other hand, the next paragraph of the proposed regulations takes a grant-by-grant approach, stating that the determination whether compensation qualifies for the performance-based-compensation exception is made "on a grant-by-grant basis. Thus, for example, whether compensation attributable to a stock option grant satisfies the requirements of [the performance-based-compensation exception] generally is determined on the basis of the particular grant made and without regard to the terms of any other option grant to the same or another employee."[73] To the same effect, the proposed regulations also state that "[o]ptions granted with an exercise price equal to, or greater than, fair market value on the date of grant do not fail to meet the requirements of [the performance-based-compensation exception] merely because

[72]Prop. reg. section 1.162-27(e)(2)(iv).

[73]Prop. reg. section 1.162-27(e)(2)(v).

the compensation committee has the discretion to determine the types of awards (i.e., options, rights, or restricted stock) to be granted to each employee or the discretion to issue options or make other compensation awards under the plan that would not meet the requirements of [the performance-based-compensation exception]. Whether an option granted under the plan satisfies the requirements of [the performance-based-compensation exception] is determined on the basis of the specific terms of the option and without regard to other options or awards under the plan."[74]

- The regulatory preamble, by contrast, takes neither an overt integration nor a grant-by-grant approach, adopting instead a rather confusing middle-of-the-road approach: Whether compensation meets the requirements of the performance-based-compensation exception is determined "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. . . . 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."[75]

Thus, it is relatively clear that an executive's straight, noncontingent salary should not be aggregated with a performance-goal award to cause the performance-goal award to be viewed as partially noncontingent. However, it also seems clear that two awards that are expressly interrelated or tandem, such as those described above, should generally be viewed together. For those arrangements that fall somewhere between the salary example and a tandem award — e.g., a discretionary nonformula cash bonus and a second cash bonus that is contingent on a qualified performance-based goal — the proposed regulations are manifestly unclear.

It is relatively clear that an executive's straight, noncontingent salary should not be aggregated with a performance-goal award.

d. Change-in-control, death, or disability 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."[76] A similar provision may accelerate vesting in the case of death or disability.

[74]Prop. reg. section 1.162-27(e)(2)(vii) (Example 9).

[75]58 *Fed. Reg.* at 66,312.

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

The statutory language of section 162(m) originally caused concern that a change-in-control, death, or disability feature in an award (even one that was never used) would prevent the award from qualifying as performance-based because such a feature would mean that the executive had some chance of receiving the compensation under the award even though the performance goals were not met. The proposed regulations eliminate this concern, stating that compensation "does not fail to be qualified performance-based compensation merely because the plan allows the compensation to be payable upon death, disability, or change of ownership or control."[77]

If the employee ceases to be employed by the corporation prior to the last day of the deduction year, such compensation will be exempt from the $1 million deduction limit.

The proposed regulations go on to state that "compensation paid on account of [death, disability, or change of control] prior to the attainment of the performance goal would not satisfy the requirements of [the performance-based-compensation exception]."[78] If, however, the employee ceases to be employed by the corporation prior to the last day of the deduction year (whether as a result of death, disability, a change of control, or otherwise), such compensation will nonetheless be exempt from the $1 million deduction limit on the ground that the executive is not a covered employee.[79] See II.D. above.

[77]Prop. reg. section 1.162-27(e)(2)(iv). A feature that allowed compensation to be paid on any other event but attainment of the performance goal would disqualify the award as performance-based. For example, an award that was payable on the executive's retirement or termination without cause would fail to qualify as performance-based (even if the executive did not retire and was not fired without cause). The corporation, however, could allow an executive to retain the award in this case without causing the award to fail as performance-based if the award remained subject to the subsequent attainment of the performance goal.

[78]Prop. reg. section 1.162-27(e)(2)(iv).

[79]An individual may continue to be a covered employee, however, if he or she ceases to be employed by the corporation on the last day of the corporation's taxable year because, in that case, he or she is an employee on the last day of the taxable year. In such case, a corporation may wish to defer payment of compensation that would otherwise be subject to the $1 million deduction limit to the following year, in order to shift the deduction to a year in which the executive is not a covered employee. Where compensation is already deferred compensation subject to section 404(a)(5), the corporation may need to defer payment only to the first day of the next year. On the other hand, compensation that is not already deferred compensation (such as an annual bonus) may have to be deferred more than 2½ months into the following year in order to defer the deduction to the following year.

e. Cash bonus. For a cash bonus payable to a covered employee to be exempted from the $1 million deduction limit, the amount of the bonus must be based on a preestablished, objective, performance formula that precludes discretion and meets the other tests described in this section II.E. Many traditional features of corporate incentive bonus arrangements raise issues under the performance-based-compensation exception.

Many corporations have traditionally created a formula bonus pool for top executives where the amount of the available pool is contingent on the attainment of one or more performance goals. Frequently, however, the corporation does not specify in advance each executive's share of the pool (i.e., the corporation determines each executive's share of the pool at some later time). In such case, the bonus arrangement will not qualify for the performance-based-compensation exception because a third party could not calculate each executive's bonus.[80]

A stock option or stock appreciation right is automatically treated as meeting the performance-goal requirement.

Many corporations have in the past calculated an executive's incentive bonus as a percentage of the executive's salary (either the salary paid to the executive during the bonus period or the executive's annual salary at the end of the bonus period). Because such an arrangement would allow a corporation "discretion" to increase an executive's bonus by increasing the executive's salary after the start of the service period, there is risk that a plan incorporating such a feature would not qualify for the performance-based-compensation exception.[81] Thus, in the absence of favorable guidance from IRS, a corporation would be well-advised to base an executive's bonus on a percentage of the executive's salary at the beginning of the service period.[82]

The authors believe that IRS should allow bonuses calculated as a percentage of an executive's salary to qualify as performance based. Salaries paid to top executives of a public corporation are typically set in an elaborate process involving comparisons to the compensation paid by comparable corporations to comparable executives. There is little reason to believe that a public corporation would manipulate an executive's base salary merely to entitle the executive to a higher bonus.

Because of these limitations on the structure of a bonus plan intended to qualify for the performance-based-compensation exception, a corporation may wish to establish one arrangement for top executives who are covered employees (or likely to be covered employees) meeting all the requirements of the performance-based-compensation exception and another, more discretionary, arrangement for executives unlikely to be covered employees that does not meet the requirements of the performance-based-compensation exception.[83] This could be accomplished either with two separate plans or with one plan offering two different types of awards.

f. Stock option or SAR.[84] The legislative history of section 162(m) states that a stock option or SAR is automatically treated as meeting the performance-goal requirement "because the amount of compensation attributable to the options or [SARs] received by the executive would be based solely on an increase in the corporation's stock price."[85] In short, 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," the legislative history takes the position that such option or SAR does "not meet the requirements for performance-based compensation" unless the vesting or exercisability of the award is conditioned on the attainment of a performance goal.[86]

The proposed regulations follow the legislative history in this respect.[87] An option or an SAR granted with an exercise price equal to (or greater than) the fair market value of the underlying stock on the grant date will meet the performance goal requirement. On the other hand, an option or SAR that is even a small amount in-the-money at grant will not meet the per-

[80]*See* prop. reg. section 1.162-27(e)(2)(vi) (Example 5).

[81]There is an additional issue under the shareholder approval and disclosure rules discussed below in II.E.3.a. Where a corporation obtains approval from shareholders for a multiyear bonus plan, the corporation must generally disclose to shareholders either (1) the formula used to calculate the amount of compensation to be paid or (2) the maximum amount of compensation to be paid to an executive. Query whether the disclosure that an executive's bonus will equal a percentage of the executive's salary at the time of payment is a formula sufficient to meet this requirement. The authors believe that final regulations should clarify that such disclosure satisfies the shareholder disclosure requirement.

[82]If desirable, a corporation could increase the base salary by an objective, preestablished amount (e.g., the increase in a specified consumer price index).

[83]Determining those executives likely to be covered employees will generally not be difficult for plans covering a short period of time (e.g., an annual incentive plan). However, where the plan covers a longer time period, it may be difficult to predict the identity of covered employees when compensation under the plan becomes deductible.

[84]Section 162(m) will be most relevant for NQOs. Where a corporation issues ISOs under section 422, it is not allowed any deduction unless the employee makes a disqualifying disposition of the ISO stock. However, because of possible disqualifying dispositions (and the fact that the ISO requirements are generally consistent with the requirements of the performance-based-compensation exception), a corporation should generally qualify its ISO plan for the performance-based-compensation exception.

[85]1993 Conf. Rep. at 587.

[86]*Id.*

[87]Prop. reg. section 1.162-27(e)(2)(iv) and (vi).

formance 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[88]).

However, it can be argued that an in-the-money option or SAR that is not immediately exercisable meets the performance goal requirement, notwithstanding that it is in-the-money at grant and has no separate performance goal for vesting. This is because the delayed exercisability of an in-the-money option or SAR is the practical equivalent of a goal that the corporation's stock not decline in value more than the in-the-money element over the period that the option or SAR cannot be exercised. Where this would otherwise be a valid performance goal, the option or SAR should not be disqualified by its in-the-money exercise price.

A stock option or SAR plan must include the maximum number of shares with respect to which any one employee could receive an award during a specified period.

A more sensible regulatory approach to an immediately exercisable in-the-money option or SAR would be to bifurcate the option or SAR so that the amount the option or SAR is in-the-money at grant does not qualify for the performance-based-compensation exception (and hence is subject to the $1 million deduction limit), while any spread attributable to post-grant appreciation in the stock is treated as performance based. The authors urge IRS to adopt this bifurcation approach in final regulations.

In light of the harsh approach of the proposed regulations — that an option or SAR that is only a small amount in-the-money does not qualify for the performance-based-compensation exception — it is unfortunate that the proposed regulations give no guidance on how to determine the fair market value of stock on the grant date. The authors believe that the final regulations should state that any reasonable method of determining fair market value is acceptable, following the rule in the section 421 regulations.[89] In particular, use of the average trading price during a reasonable period before the grant date should be acceptable.[90] Moreover, the regulations should state that a good faith effort to value stock for this purpose will be respected.[91]

The proposed regulations contain one additional requirement that must be met if a stock option or SAR plan is to qualify for the performance-based-compensation exception. Under the proposed regulations, a stock option or SAR plan must include the maximum number of shares with respect to which any one employee could receive an award during a specified period.[92] The mere fact that a plan contains an aggregate limit on the number of shares that may be issued to all employees under the plan does not meet this requirement. Furthermore, the language of the proposed 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, although the authors understand that such a result is under consideration for the final regulations.

However, the proposed regulations contain a special transitional rule for plans or agreements approved by shareholders before December 20, 1993, generally waiving compliance with the per-employee maximum until the corporation's first election of directors after December 31, 1996, so long as the plan states the maximum number of shares in the aggregate that may be issued to all employees. To qualify for this transitional relief, the proposed regulations require that the "directors establishing and administering the plan or agreement [be] disinterested directors" within the meaning of Rule 16(b)-3 under the 1934 act and that the plan be approved by shareholders "in a manner consistent with" such SEC rule.[93] See III.A. below.

g. Restricted stock. The legislative history states 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."[94]

Thus, 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 preestablished objective performance goals (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.[95]

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

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[88]For example, the exercise of the option or SAR with an in-the-money exercise price at grant could be conditioned on a further rise in the value of the underlying stock over the fair market value at grant. In this case, the requirement of a further rise in value should generally be a valid performance goal.

[89]*See* reg. section 1.421-7(e)(2). *See also* prop. reg. section 1.422A-2(e)(1) adopting reg. section 1.421-7(e)(2) in the case of ISOs.

[90]*See* reg. section 1.425-1(a)(7).

[91]*Compare* section 422(c)(1) providing a "good faith" rule for valuing stock subject to an incentive stock option. *See also* temp. reg. section 14a.422A-1 Q&A 2(c)(4) and prop. reg. section 1.422A-2(e)(2).

[92]Prop. reg. section 1.162-27(e)(2)(vi)(A). The legislative history of section 162(m) was ambiguous on this point. *See* 1993 Conf. Rep. at 587.

[93]Prop. reg. section 1.162-27(h)(3)(i).

[94]1993 Conf. Rep. at 587.

[95]As discussed above, a mere time-based vesting relating to the executive's continued employment would not qualify as a performance goal.

met, the corporation should consider whether to require its executives to forego a section 83(b) election to be taxed on the receipt of restricted stock, so that the restricted stock will 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 might be viewed as preventing compliance with the first and fourth requirements of the performance-based-compensation exception.[96] See IV.B. below for a further discussion of this issue.

The statute states merely that the compensation committee must be composed solely of two or more 'outside' directors.

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 as 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.

The authors believe that the better answer would be for IRS to view the grant as (1) restricted stock which is performance based because of an objective formula vesting goal and (2) dividends which are not performance based. However, the proposed regulations generally refuse to bifurcate a single award into a contingent and a noncontingent component so that the contingent component could satisfy the performance-based-compensation exception. See II.E.1.f. above. If the proposed regulations are adopted in their current form, the unrestricted right to receive cash dividends would apparently prevent a restricted stock award from qualifying for the performance-based-compensation exception. Thus, the restricted stock grant should (i) give the executive no right to dividends[97] 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.[98]

2. Goal set by compensation committee. The second requirement of the performance-based-compensation exception is that the performance goal be determined by a compensation committee comprised solely of two or more outside directors.[99] The statute states merely that the compensation committee must be composed solely of two or more "outside" directors and does not define "outside" director. The compensation committee would be tainted if even one member fails the test as an "outside" director.

a. Outside director. The legislative history of section 162(m) 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,[100]
- was not an officer of the corporation or a "related" entity at any time,
- 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).[101]

Under the legislative history, a director who is "currently receiving compensation for personal services in any capacity . . . other than as a director" is not an outside director.[102] The proposed regulations greatly expand this disqualification rule, dropping the requirement that the services furnished be "personal" and adding a prohibition on remuneration for furnishing "goods" as well as services.[103] IRS's authority for this drastic expansion is not at all clear.

Under the proposed regulations, an amount paid by the corporation to an entity is considered paid to a director if:

(1) the director has a beneficial ownership interest of more than 50 percent in the entity, *or*

(2) the director has a beneficial ownership interest in the entity of more than 5 percent and less than 50 percent, unless the compensation is *de minimis, or*

(3) the entity is an "entity by which the director is employed (including self-employed)," unless the compensation is *de minimis.*[104]

[96]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 of the restricted stock equal to the stock's then value, 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).

[97]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.

[98]The same issue would arise where dividend equivalents are paid currently or accrued with respect to a stock option or SAR.

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

[100]The legislative history is wholly silent on the meaning of "related."

[101]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.

[102]1993 Conf. Rep. at 587.

[103]Prop. reg. section 1.162-27(e)(3)(ii).

[104]*Id.*

Compensation is considered *de minimis* if, during the corporation's prior taxable year, it is less than the *smaller* of (1) $60,000 or (2) 5 percent of the entity's gross income.[105]

Thus, if the proposed regulations are adopted in their current form, a director of the publicly held corporation is disqualified as an outside director where he or she is an employee of (or self-employed by) an entity that sells more than $60,000 of goods or services to the publicly held corporation.[106] This standard is irrationally broad in the class of directors disqualified. For example, an executive of the phone company used by the publicly held corporation would be disqualified as an outside director if the corporation purchases more than $60,000 worth of phone service in a year. Indeed, in such case, the rule may also disqualify a director of the phone company who is not even an employee of the phone company (on the ground that the outside director is self-employed by the phone company) from serving as one of the corporation's outside directors.[107] Given the business relationships common among large corporations and the overlap between many boards of directors, it is quite possible that many publicly held corporations currently have no "outside" directors as defined by the proposed regulations.[108]

The authors believe that the final regulations should (1) adopt a *de minimis* threshold of the *greater* of $60,000 or 5 percent of the entity's gross income and (2) limit disqualification to cases in which "personal services" (generally legal, accounting, investment banking, consulting, etc.) are provided.[109]

While the proposed regulations limit the definition of outside director based on whether the publicly held corporation purchases goods or services from the director or his or her employer, the statute and proposed regulations do not impose a similar limitation based on goods or services sold by the publicly held corporation to the director or his or her employer. Thus, for example, where the publicly held corporation sells substantial manufactured goods to the phone company, an employee of the phone company may still qualify as an outside director of the publicly held corporation.

The proposed regulations make one other change from the legislative history. In determining who is an outside director, the proposed regulations drop any reference to "related" entities. In effect, the proposed regulations have substituted "affiliated" corporations (in section 1504's 80-80 sense) for "related entities" for this purpose, since a publicly held corporation includes the members of its affiliated group.[110]

b. Transitional rules. In an implicit recognition of the surprisingly harsh approach of the proposed regulations on the meaning of "outside director," the proposed regulations contain an important ameliorating transitional rule treating as a qualified outside director until the corporation's first election of directors that occurs after July 1, 1994, any person who is a "disinterested director" for SEC purposes under current SEC Rule 16b-3(c)(2)(i) (New SEC Section 16(b) Rules) or under SEC Rule 16b-3(d)(3) as it was in effect on April 30, 1991 (Old SEC Section 16(b) Rules).[111] See III.B. below.

For a discussion of another special transitional rule that applies to certain plans or agreements approved by shareholders before December 20, 1993, see III.A. below. This special transitional rule would waive compliance with the proposed regulation's stringent standards for determining outside directors in connection with such a preexisting plan. This waiver would generally last until the corporation's first election of directors after December 31, 1996. To qualify for this transitional relief, the proposed regulations require that the "directors establishing and administering the plan or agreement are disinterested directors" within the meaning of the New or Old SEC Section 16(b) Rules and that the plan be approved by shareholders "in a manner consistent with" such SEC rules (see II.E.2.c. below).[112]

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[105]Prop. reg. section 1.162-27(e)(3)(iii).

[106]The $60,000 figure may come from SEC Regulation S-K, Item 404, which requires that certain transactions between the corporation and others involving more than $60,000 be disclosed. Several important differences should be noted. First, Item 404 merely requires that certain transactions be disclosed; it does not prevent anyone from being "disinterested" for SEC purposes. Second, Item 404 has a number of exceptions to its rules (e.g., exceptions for transactions that are the subject of competitive bids, payments to common carriers or public utilities, and payments to a company where the only relationship to the corporation on the other side is a nonexecutive director). Unfortunately, none of these exceptions is picked up by the proposed regulations.

[107]On the other hand, it may be possible to argue that the nonemployee director of the phone company should not be disqualified as an "outside" director on the ground that he or she receives remuneration only in the capacity as a director of the phone company. The proposed regulations state that an individual cannot receive remuneration, directly or indirectly, in any capacity other than as a director. Thus, any indirect payment that the director of the phone company is deemed to receive because the corporation obtains its phone service from the phone company is remuneration to the director in his or her capacity as a director of the phone company (although not in his or her capacity as a director of the publicly held corporation at issue). *See* prop. reg. section 1.162-27(e)(3)(i)(D).

[108]Even a university president or professor who serves as a director of a publicly held company may fail to be an "outside" director, if, for example, the corporation pays tuition for its employees and executives who attend the university.

[109]It is interesting that, while the proposed regulations are dramatically overbroad in excluding certain directors from the definition of "outside" director, they are curiously lax in other respects. Thus, for example, any one of the following would appear eligible to be an "outside" director (assuming that they meet the other tests): (1) the CEO's spouse or other family member, (2) the CEO's personal (as opposed to the publicly held corporation's) lawyer, accountant, or financial advisor, or (3) the CEO's (as opposed to the publicly held corporation's) full-time employee.

[110]Prop. reg. section 1.162-27(e)(3) and (c)(1)(ii).

[111]Prop. reg. section 1.162-27(h)(2).

[112]Prop. reg. section 1.162-27(h)(3)(i).

c. Role of compensation committee. The proposed regulations state that the compensation committee is "the committee of directors (including any subcommittee of directors) . . . that has the authority to establish and administer a performance-based compensation arrangement" (except that the board of directors can, as discussed below, have the authority to ratify compensation committee action).[113] The requirement that the compensation committee "establish" a performance-based compensation arrangement reflects a misunderstanding of the way in which a corporation typically adopts a compensation plan. Furthermore, both the statute and legislative history merely state that the compensation committee must establish the goals, not establish the plan.[114]

Typically, a corporation's full board of directors adopts the plan (as opposed to merely ratifying a plan adopted by the compensation committee); the shareholders approve the plan; and the compensation committee thereafter administers the plan. This typical procedure is consistent with the New or Old SEC Section 16(b) Rules, which merely require that a disinterested committee of the board of directors administer the plan where some directors (e.g., executive directors) are entitled to participate. Under these SEC rules, the committee need not also establish the plan. This typical procedure would apparently not comply with the literal requirements of the proposed regulations because the board of directors (which "establishes" the plan) will virtually always have one or more directors who are not outside directors for purposes of section 162(m).

Shareholder approval must be obtained prior to the time when the compensation would otherwise be deductible by the corporation.

The authors understand that IRS is likely to eliminate the requirement that a plan be "established" by the compensation committee for purposes of the transitional rule for existing plans. See III.A. below. However, IRS apparently does not intend to eliminate the requirement for new plans. The authors urge IRS to drop this requirement for both existing and new plans. In the authors' view, it should be sufficient that the compensation committee determines the awards to be made under the plan. Requiring that the compensation committee "establish" the plan serves little use from a policy perspective and provides a technical trap for the unwary.[115]

The proposed regulations allow the compensation committee to be a subcommittee of another board of directors committee and allow the decisions of the compensation committee to be subject to ratification by another board of directors committee (containing non-outside directors) or the entire board of directors (containing non-outside directors).[116]

The proposed regulations apparently require the compensation committee to make all grants and awards intended to qualify for the performance-based-compensation exception.[117] The proposed regulations state that the committee must "administer a performance-based compensation arrangement" and, in discussing the particular requirements of option or SAR plans, state that the compensation committee must approve each grant or award.[118]

3. Shareholder disclosure and vote. 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) be disclosed to shareholders and approved by a separate majority shareholder vote.[119] The legislative history states that the executive's right to receive the compensation must be contingent on a separate shareholder approval.[120] Thus, where shareholder ap-

[113]Prop. reg. section 1.162-27(c)(4).

[114]*See* section 162(m)(4)(C)(i); 1993 Conf. Rep. at 586.

[115]As noted immediately below, under the proposed regulations, the adoption of a plan may still be subject to the approval of the board of directors. Thus, the requirement that the compensation committee "establish" the plan seems to mean only that it must approve the plan first, before the board of directors votes on the plan.

[116]Prop. reg. section 1.162-27(c)(4).

[117]Where an 80-percent-or-greater subsidiary is a member of a publicly held corporation's affiliated group (but the subsidiary is not itself publicly held without regard to section 1504), the parent's compensation committee (and not the subsidiary's compensation committee) should approve a grant or award to the subsidiary's employee if the grant or award is intended to qualify for the performance-based-compensation exception. Under the proposed regulations, the publicly held parent corporation is treated as including its affiliated subsidiary. *See* prop. reg. section 1.162-27(c)(1)(ii).

Where the affiliated subsidiary is itself publicly held (i.e., publicly held without regard to section 1504), it is unclear whether the parent's or subsidiary's compensation committee must make grants or awards of the parent's stock to a covered employee of the subsidiary (who is not independently a covered employee of the parent). The authors believe that final regulations should clarify that it is permissible for the parent's compensation committee to administer such a grant or award in order to reflect the fact that it is the shareholders of the parent corporation (and not the shareholders of the subsidiary) who are diluted. In addition, however, the authors believe that final regulations should also permit the subsidiary's compensation committee to administer such a grant or award because the beneficiary of the compensation is a covered employee of the subsidiary.

Where such a publicly held affiliated subsidiary grants compensation other than parent stock (e.g., cash or subsidiary stock) to the subsidiary's employee (who is not independently covered employee of the parent), it appears that the subsidiary's compensation committee should approve the grant or award. However, the authors would not object to permitting approval by the parent's compensation committee.

[118]Prop. reg. section 1.162-27(e)(2)(i) and (vi).

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

[120]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).

proval 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.

Shareholder approval must be obtained prior to the time when the compensation would otherwise be deductible by the corporation and need not be obtained prior to the grant or award.[121] 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.

Shareholder approval means the approval by a majority of the votes cast, not by a majority of all the outstanding shares.[122] Neither the legislative history nor the proposed regulations suggests that the majority vote must be calculated by excluding any particular shares, such as those owned by the covered executive.[123]

A drafting error in the proposed regulations describes the shareholder approval rule incorrectly in the case of a corporation with multiple classes of stock outstanding with different voting powers. The proposed regulations currently state that the requisite shareholder approval is obtained if "affirmative votes are cast by a majority of the voting shares" (other than abstaining shares).[124] If a corporation has, for example, one class of stock entitled to 10 votes per share and another class of stock entitled to 1 vote per share, approval by a majority of the "voting shares" is different from approval by a majority of votes. The relevant portion of the proposed regulations should be revised to read as follows: "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 are cast in favor of such approval*" (emphasis added).

a. Disclosure. The proposed regulations clarify the information a publicly held corporation must disclose to shareholders to obtain shareholder approval of performance-based compensation. Under the proposed regulations, a corporation must generally disclose each of the following:

- The individuals eligible to receive the compensation (who may be identified by name, by title, or by class of executive). The proposed regulations make clear that a reference to "all salaried employees" or to "all executive officers" is adequate but do not explicitly approve "key employees."[125]
- A description of the "business criteria on which the performance goal is based," which "need not include [(1)] the specific targets . . . under the performance goal" or (2) any information determined by the compensation committee to be "confidential commercial or business information the disclosure of which would have an adverse effect" on the corporation (e.g., a schedule for developing a new product), so long as the disclosure to shareholders states that such information has been omitted as confidential information.[126]

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[121]Where an 80-percent-or-greater subsidiary is a member of a publicly held corporation's affiliated group (but the subsidiary is not itself publicly held without regard to section 1504), the parent's shareholders (and not the shareholders of the subsidiary that is 80 percent or more owned by the parent) should approve a grant or award (or a plan providing for such grant or award) to the subsidiary's employee if the grant or award is intended to qualify for the performance-based-compensation exception. Under the proposed regulations, the publicly held parent corporation is treated as including its affiliated subsidiary. *See* prop. reg. section 1.162-27(c)(1)(ii).

Where the affiliated subsidiary is itself publicly held (i.e., publicly held without regard to section 1504), it is unclear whether the parent's or subsidiary's shareholders must approve grants or awards of the parent's stock to a covered employee of the subsidiary (who is not independently a covered employee of the parent). The authors believe that final regulations should clarify that it is permissible for the parent's shareholders to approve the grant or award. Such an approach would reflect the fact that it is the shareholders of the parent corporation (and not the shareholders of the subsidiary) who are diluted. Moreover, permitting parent shareholder approval would also be consistent with general corporate practice as to shareholder approval where parent stock or an option to acquire parent stock is granted to subsidiary employees. It appears that approval by the shareholders of the subsidiary would also be sufficient.

Where a publicly held affiliated subsidiary grants compensation other than parent stock (e.g., cash or subsidiary stock) to the subsidiary's employee (who is not independently a covered employee of the parent), it appears that the subsidiary's shareholders should approve the grant or award. However, the authors would not object to permitting approval by either the parent's or the subsidiary's shareholders.

[122]Section 162(m)(4)(C)(ii); prop. reg. section 1.162-27(e)(4)(vii); 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).

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

[124]Prop. reg. section 1.162-27(e)(4)(vii).

[125]Prop. reg. section 1.162-27(e)(4)(i) and (ii).

[126]Prop. reg. section 1.162-27(e)(4)(i) and (iii). The proposed regulations use the following terms: (1) "business criterion" or "business criteria" means the general category or categories used to define a goal (e.g., EBIT, EPS, share price, return on equity, etc.), (2) "specific target" or "target" means the specific numerical amount which must be equalled or exceeded in order for a performance goal to be attained, and (3) "performance goal" or "goal" means the combination of a business criterion, a formula, and a specific target.

- Either (1) "the maximum amount of compensation that is payable to an individual" or (2) sufficient information "so that shareholders can determine the maximum amount of compensation that could be paid to any employee" or (3) "the formula used to calculate the amount of compensation."[127]

Where the proposed regulations do not provide specific guidance, SEC principles govern whether disclosure is adequate.[128]

Shareholder approval is good for only five years and the plan must be reapproved by shareholders after five years.

The proposed regulations would allow a publicly held corporation to obtain shareholder approval once for a multiyear plan so long as the compensation committee does not, after such approval, change the material terms of the performance goal(s) disclosed to shareholders. However, if the plan allows the compensation committee to change the targets under a performance goal (e.g., by setting a new annual target each year), shareholder approval is good for only five years and the plan must be reapproved by shareholders after five years.[129]

Hence, where the plan (and shareholder disclosure) state that the business criteria are sales, EBIT, EPS, share price, and/or return on equity and that the compensation committee will from time to time set specific targets based on these business criteria, the plan (1) must be approved by shareholders, (2) must be reapproved if the business criteria are materially changed, and (3) in any event must be reapproved by shareholders after five years.

b. Transitional rule. The proposed regulations provide a special transitional rule that applies to certain plans or agreements approved by shareholders before December 20, 1993. See III.A. below. This special transitional rule would waive compliance with the proposed regulation's stringent shareholder disclosure and approval requirements in connection with such a preexisting plan. This waiver would generally last until the corporation's first election of directors after December 31, 1996. To qualify for this transitional relief, the proposed regulations require that the "directors establishing and administering the plan or agreement are disinterested directors" within the meaning of either New or Old SEC Section 16(b) Rules[130] and that the plan be approved by shareholders "in a manner consistent with" either New or Old SEC Section 16(b) Rules.[131] As noted in III.A. below, the authors understand that IRS is likely to drop the requirement that the compensation committee "establish" the plan, but only for purposes of the transitional rule.

4. Compensation committee 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.[132] The legislative history states that the executive's right to receive the compensation must be contingent on certification. However, according to the legislative history and the proposed regulations, certification is not required in the case of a stock option or SAR otherwise meeting the first three requirements.[133]

Although the proposed regulations require the compensation committee to certify that the "performance goals and any other material terms were in fact satisfied," Treasury personnel have informally stated that the reference to "other material terms" was not intended to create an additional substantive requirement for the performance-based-compensation exception. The authors believe that the final regulations should clarify that the compensation committee need only certify that the performance goals were met and need not certify that other conditions to the award that are not performance goals were met. Thus, for example, a corporation should be entitled to waive a vesting restriction that requires the executive's continued employment with the corporation without fear that the waiver would cause the loss of the performance-based-compensation exception (by preventing the compensation committee from certifying that the other material terms of the award have been met).[134] In short, the authors believe that as the proposed regulations are now drafted, the "other material terms" are the non-performance-based terms in effect, as modified, on the date of payment.

F. Exception #5: Grandfathered Arrangement

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.[135] 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 sub-

[127]Prop. reg. section 1.162-27(e)(4)(i) and (iv).

[128]Prop. reg. section 1.162-27(e)(4)(v).

[129]Prop. reg. section 1.162-27(e)(4)(vi).

[130]*See* II.E.2.b. for the definition of New and Old SEC Section 16(b) Rules.

[131]Prop. reg. section 1.162-27(h)(3)(i).

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

[133]1993 Conf. Rep. at 587; prop. reg. section 1.162-27(e)(5).

[134]Prop. reg. section 1.162-27(e)(2)(iii)(B) indicates that where a transfer of stock is subject to the attainment of both a performance goal and a vesting schedule, the corporation may "change" the vesting schedule to defer or accelerate the transfer of stock without being treated as increasing the compensation under the award. This provision of the proposed regulations would be superfluous if a change to the vesting schedule were viewed as a change to the material terms of the award, thus preventing compensation committee certification.

[135]Section 162(m)(4)(D).

ject to discretion, i.e., the corporation is obligated to make the payment.

1. Binding contract in effect on February 17, 1993. Under the proposed regulations, a written contract is binding where "under applicable state law, the corporation is obligated to pay the compensation if the employee performs services."[136] Where the contract is "terminable or cancelable by the corporation after February 17, 1993, without the employee's consent, [the contract] is treated as a new contract as of the date that any such termination or cancellation, if made, would be effective" and ceases to be grandfathered thereafter.[137] Similarly, a contract that is renewed after February 17, 1993, is treated as a new contract that was not binding on February 17, 1993, and hence does not qualify for the grandfather rule.[138]

a. Plan or arrangement. A mere plan that permits the corporation to make a future discretionary award or a future contract would generally appear not to be a binding contract because the corporation is not "obligated to pay the compensation if the employee performs the services." Thus, the grandfather rule would appear not to protect a post-February 17, 1993, award or contract merely because it is made pursuant to a pre-February 18, 1993, plan.

The proposed regulations indicate that a "plan or arrangement" may in some cases be a "written binding contract" for purposes of the grandfather rule.[139] Thus, for example, a bonus plan adopted by a corporation prior to February 18, 1993, that provided for a specific award to eligible executives would qualify for the grandfather rule if the plan creates a binding legal obligation on the part of the corporation to pay the compensation.

However, the grandfather rule for pre-February 18, 1993, plans and arrangements may be broader. The proposed regulations also state that where a plan or arrangement is a written binding contract, the grandfather rule applies "even though the employee was not eligible to participate in the plan as of February 17, 1993," so long as "the employee was employed [by the corporation] on February 17, 1993 . . . or the employee had the right to participate in the plan or arrangement under a written binding contract as of that date."[140] Thus, at least in the case of an employee who was not eligible to participate in a plan on February 17, 1993, but who later becomes eligible, the grandfather rule applies to a benefit under a plan that the corporation was not legally bound to pay by contract on February 17, 1993, and only became bound to pay based on subsequent events that were presumably at least partly in the corporation's control (e.g., the executive's promotion).

Thus, it is not wholly clear whether the grandfather rule would apply where the corporation had, before February 18, 1993, adopted a binding plan calling for a bonus (each year through 2000) to corporate officers equal, in the aggregate, to 3 percent of the corporation's net income, granting the board of directors or a committee discretion to allocate this amount among the corporate officers.[141] It is possible that the discretionary allocation right would destroy grandfathering. However, the authors believe that such a plan should be covered by the grandfather rule because the corporation is required to pay the compensation in the aggregate, even though no one executive is entitled to a specific amount. If the grandfather rule applies, it appears that a bonus to a particular officer would be grandfathered only if he or she (1) were eligible to participate in the plan on February 17, 1993, or (2) were employed by the corporation on February 17, 1993 (even if not yet an officer on February 17, 1993), or (3) had a contract on February 17, 1993, giving him or her the right to participate when he or she became an employee.

The proposed regulations are unclear and contradictory on the extent to which a plan or arrangement may be covered by the grandfather rule.

The proposed regulations, as described above, are unclear and to some extent contradictory on the extent to which a plan or arrangement may be covered by the grandfather rule. The final regulations should, at a minimum, clarify the intended scope and include an example of the application of the grandfather rule to a plan or arrangement.

b. Discretionary payments. The proposed regulations do not specifically state that the grandfather rule is inapplicable to discretionary benefits under a pre-February 18, 1993, plan or arrangement. However, the proposed regulations do state, with respect to a contract, that the compensation must be "payable under a written binding contract that was in effect on February 17, 1993," and that "under applicable state law, the corporation [must have been] obligated to pay the compensation if the employee performs services."[142] Hence, with respect to a grandfathered contract, it appears that a payment permitted but not required under the contract is not grandfathered.

Thus, where a corporation agreed under a pre-February 18, 1993, contract to pay an executive a fixed salary, a minimum bonus, and a discretionary bonus in excess of the minimum bonus, the discretionary bonus, if paid, appears not to qualify for the

[136]Prop. reg. section 1.162-27(h)(1)(i).

[137]*Id.*

[138]*Id.*

[139]Prop. reg. section 1.162-27(h)(1)(ii).

[140]*Id.*

[141]Although the liability to any one officer may be contingent since the officer may forfeit his or her rights to a bonus by leaving the corporation's employ, the corporation may accrue the deduction once the amount owed to the group is fixed under the "all events" test. *See Washington Post Co. v. United States*, 405 F.2d 1279 (Ct. Cl. 1969).

[142]Prop. reg. section 1.162-27(h)(1)(i).

grandfather rule. However, as discussed below, the payment (or nonpayment) of the discretionary bonus should not constitute a material modification of the contract and hence should not adversely affect the ability of the fixed salary and fixed bonus to qualify for the grandfather rule.

A supplemental contract or even the mere payment of additional compensation without a supplemental contract may be integrated with a grandfathered contract.

2. Material modification. Because a material modification of an old (pre-February 18, 1993) contract or award will result in loss of grandfather protection, a publicly held corporation and its executives should be careful about making any changes to old compensation arrangements. The proposed regulations state that a material modification of a grandfathered contract occurs "when the contract is amended to increase the amount of compensation payable to the employee" (except an increase not exceeding a reasonable cost-of-living increase, as described below).[143] Thus, it appears that an amendment that causes any increase in excess of a reasonable cost-of-living increase (as described below) will destroy grandfathering. However, it appears that an amendment that does not *increase* the amount of the employee's compensation does not destroy grandfathering.

The proposed regulations further state:

> The adoption of a supplemental contract or agreement that provides for increased compensation, or the payment of additional compensation, is a material modification of a binding, written 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.[144]

It appears, under the quoted language, that a supplemental contract or even the mere payment of additional compensation without a supplemental contract may be integrated with a grandfathered contract and hence may destroy grandfathering. In this respect, the material modification test for a grandfathered contract apparently incorporates an approach similar to the aggregation rule discussed in II.E.1.c. above, leaving the scope of the material modification rule unclear.

The proposed regulations create an exception from this general rule under which a material modification is not triggered by (1) "a supplemental payment that is equal to or less than a reasonable cost-of-living increase" or (2) a payment that qualifies for the performance-based-compensation exception.[145]

[143]Prop. reg. section 1.162-27(h)(1)(iii).

[144]Prop. reg. section 1.162-27(h)(1)(iii)(C).

[145]*Id.*

It is not clear when "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."[146] One example makes clear that a restricted stock grant which does not qualify for the performance-based-compensation exception is nonetheless sufficiently different from salary paid pursuant to a grandfathered contract because the restricted stock grant is "based . . . on the stock price."[147] Another example strongly implies that any salary increase or salary payment is integrated with the contractual salary payments.[148] However, additional salary should be sufficiently separate if the additional salary is for additional duties or additional services.

Moreover, the authors believe that grandfathering should not be lost for contractually fixed payments of salary and bonus where the contract also (1) permits the corporation to pay a completely discretionary bonus and the corporation does so or (2) requires the corporation to pay a bonus between two specified amounts and the corporation pays a greater bonus than the contractual minimum. While such discretionary bonus payments appear not to qualify for the grandfather rule, their payment should not be viewed as a material modification of the contract. As long as the payment of a discretionary bonus amount is within the terms of the pre-February 18, 1993, contract, the payment of the discretionary bonus is not a modification at all. It would be helpful if the final regulations acknowledged this point, at least in an example. Query whether grandfather protection for a pre-February 18, 1993, salary contract will be lost if the corporation pays the executive an additional discretionary bonus not mentioned at all in the contract.

Where there is a mere substitution of parties, the result is not an increase in compensation, and there should be no material modification.

3. Assumption of grandfathered obligation. Special problems arise when one corporation (P) acquires the stock or assets of another corporation (T). 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.[149] Such an assumption should not be treated as a material modification, unless the terms of the compen-

[146]*Id.*

[147]Prop. reg. section 1.162-27(h)(1)(iv) (Example 3).

[148]Prop. reg. section 1.162-27(h)(1)(iv) (Example 2).

[149]This discussion assumes that the T executive whose compensation arrangement is being assumed by P is a covered employee of P after the acquisition.

sation agreement (other than the identity of the party obligated to pay the compensation) are materially modified in connection with the assumption. In short, where there is a mere substitution of parties, the result is not an increase in compensation, and there should be no material modification.

A fiscal year corporation may be able to accelerate the payment or tax accrual of compensation to a covered executive to beat the effective date of the new provision.

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 should 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). The proposed regulations do not address this issue, and specific guidance in this area would be desirable.[150]

G. Exception #6: Year Beginning Before 1994

The $1 million deduction limit does not apply to any amount that is deductible during a corporation's taxable year beginning before January 1, 1994.[151] For a calendar-year corporation, this means the $1 million deduction limit does not apply to 1993. For a fiscal year corporation with a year ending on (e.g.) June 30, this means the deduction limit does not apply to its year ending June 30, 1994.

A fiscal year corporation may, therefore, be able to accelerate the payment or tax accrual of compensation to a covered executive to beat the effective date of the new provision. At this time, any ability to use this technique for planning is limited to a corporation whose 1994 fiscal year has not yet ended.[152]

For such a fiscal year corporation:

- Compensation paid to an executive in cash (or properly accrued for tax purposes) prior to the end of its 1994 fiscal year is not subject to the $1 million deduction limit.
- An NQO exercised (or an ISO with a disqualifying disposition) prior to the end of its 1994 fiscal year is not subject to the deduction limit (where the stock received on exercise is not subject to post-exercise vesting).

A special rule applies to a fiscal year corporation that (1) 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 (2) grants an NQO to an executive that later exercises the NQO, receives restricted stock subject to vesting, and makes a section 83(b) election with respect to the receipt of the restricted stock, or (3) makes a payment under a deferred compensation plan. Under this special rule, such restricted stock grant, NQO exercise, or deferred compensation payment must have occurred no later than December 31, 1993, to beat the effective date of the new deduction limit (even though the corporation is on a fiscal year).[153]

H. Exception #7: Commissions

The $1 million deduction limit does not apply to compensation "payable on a commission basis solely on account of income generated directly by the in-

[150]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. In such case, 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 because the old option so qualified. This issue is relevant where the new P option would not by itself qualify for the performance-based-compensation exception because (as is likely) the P option is in-the-money at the time of the assumption or because the P option may not have been approved by P shareholders.

Again, the authors believe that 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 (1) the T option qualified for such exception when issued and (2) the assumption would qualify under the principles of section 424(a) and (h).

[151]Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, section 13211(b) (1993). A 52-53 week calendar-year taxpayer would be subject to section 162(m) starting January 1, 1994, because, for purposes of the effective date, the corporation's taxable year is deemed to end on the last day of the calendar month ending nearest to the last day of the corporation's taxable year. Section 441(f)(2)(A)(ii).

[152]In some cases, a corporation whose 1994 fiscal year has already ended may avoid the $1 million limit by promptly paying out compensation which became fixed during its 1994 fiscal year and hence would be properly deductible so long as paid within 2½ months after the end of such year. If such compensation is not paid within 2½ months, it may become deferred compensation deductible under section 404(a)(5) after the effective date of section 162(m).

[153]This special rule arises because, under section 83(h), the corporation's section 83(b) 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 (where the executive makes a section 83(b) election) by the corporation in its year beginning July 1, 1994, a year 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.

dividual performance of the [executive] to whom such [compensation] is payable."[154]

The good news is that this exception does not require a compensation committee and/or shareholder vote, as does the performance-based-compensation exception. The bad news is that this exception will almost never be of use with regard to 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.[155] Hence, this is an extremely narrow exception that is unlikely to apply to compensation earned by the top five officers of a publicly held corporation.

III. Transitional Rules

A. Plans Approved Before December 20, 1993

There are several liberalizing transitional rules for any plan or agreement approved by shareholders prior to December 20, 1993. Such a plan is treated as satisfying both (1) the shareholder disclosure and approval requirements discussed in II.E.3. above (even though the prior shareholder disclosure and approval did not meet all the technical requirements of the proposed regulations) and (2) the compensation committee requirements discussed in II.E.2. above (even though the composition of the compensation committee does not meet all the technical requirements of the proposed regulations).

In addition, where this transitional rule applies to a plan covering stock options and/or SARs, the transitional rule also waives compliance with the requirement that such a stock-based plan state the maximum number of shares with respect to which an option or SAR may be granted to an employee, so long as the plan states an aggregate limit on the number of shares with respect to which awards may be made under the plan (see II.E.1.f. above).[156]

This transitional rule is available where the following conditions are met:

- "[T]he plan was approved by shareholders [prior to December 20, 1993] in a manner consistent with" SEC principles (i.e., under New or Old SEC Section 16(b) Rules[157]).
- "[T]he directors establishing and administering the plan or agreement are disinterested directors" within the meaning of the New or Old SEC Section 16(b) Rules.[158]

Generally, a public corporation would have obtained shareholder approval for a plan or agreement only if it was stock-based so that SEC Rule 16b-3 would (if complied with) provide certain exemptions from the short-swing profit rules of 1934 act section 16(b). In some cases, cash arrangements may have been approved by shareholders if the arrangements were included in a larger plan that also included stock-based awards.

This liberalizing transitional relief expires (and hence the plan must be approved by shareholders in compliance with all the technical requirements of the proposed IRS regulations and the compensation committee must comply with all the technical requirements of the proposed IRS regulations) at the time of the corporation's first election of directors after December 31, 1996 (or if earlier, the date on which the plan expires or is materially modified or, for a stock-based plan, the date on which all of the stock authorized under the plan has been issued, if earlier). For a discussion of "materially modified," see II.F.2. above.

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

[155]Prop. reg. section 1.162-27(d).

[156]The proposed regulations require the maximum number of shares to be expressed as an absolute number rather than permitting the requirement to be expressed as a percentage of outstanding shares. This limitation is a larger problem in the transitional rule than in the ordinary rule requiring an absolute per employee maximum for all option or SAR plans (see II.E.1.f. above) because the transitional rule deals with plans that are already in existence. The authors understand that IRS is considering whether to allow plans which state that the aggregate maximum is based on a percentage of outstanding shares to qualify for the transitional rule. The authors believe that the final regulations should so extend the transitional rule. However, it may be appropriate for IRS to treat such a plan as if it contained an absolute aggregate limit equal to the percentage stated under the plan multiplied by the corporation's outstanding shares on December 20, 1993 (even if the corporation's outstanding shares increase after December 20, 1993).

[157]*See* II.E.2.b. for the definition of New and Old SEC Section 16(b) Rules.

[158]Prop. reg. section 1.162-27(h)(3)(i). The New SEC Section 16(b) Rules provide the following definition of disinterested director:

> a director who is not, during the one year prior to service as an administrator of a plan, or during such service, granted or awarded equity securities pursuant to the plan or any other plan of the issuer or any of its affiliates, except that: (A) participation in a formula plan . . . shall not disqualify a director from being a disinterested person; (B) participation in an ongoing securities acquisition plan . . . shall not disqualify a director from being a disinterested person; (C) an election to receive an annual retainer fee in either cash or an equivalent amount of securities, or partly in cash and partly in securities, shall not disqualify a director from being a disinterested person; and (D) participation in a plan shall not disqualify a director from being a disinterested person for the purpose of administering another plan that does not permit participation by directors.

SEC Rule 16b-3(c)(2)(i), as currently in effect. The Old SEC Section 16(b) Rules provide the following definition of disinterested director:

> an administrator of a plan who is not at the time he [or she] exercises discretion in administering the plan eligible and has not at any time within one year prior thereto been eligible for selection as a person to whom stock may be allocated or to whom stock options or [SARs] may be granted pursuant to the plan or any other plan of the issuer or any of its affiliates entitling the participants therein to acquire stock, stock options or [SARs] of the issuer or any of its affiliates.

SEC Rule 16b-3(d)(3), as in effect on April 30, 1991.

Although the wording of the transitional rule is somewhat ambiguous, it was clearly intended to protect awards made under qualifying plans through the end of the permitted transition period (generally the first election of directors after December 31, 1996, as described above), even if the compensation attributable to the award becomes deductible, e.g., through the later exercise of an NQO or an SAR, after the expiration of the transitional rule. The final regulations should clarify this ambiguity.

> ***It appears that the IRS did not intend the transitional rule to be this narrow.***

This special transitional rule may be narrower than it appears at first glance. Read literally, it does not apply merely because the corporation adopted and the shareholders approved a plan prior to December 20, 1993, in compliance with SEC Rule 16b-3. Rather, the transitional rule also requires that the "directors *establishing* and administering the plan or agreement" (emphasis added) be disinterested directors within the meaning of the New or Old SEC Section 16(b) Rules.

However, neither the New nor the Old SEC Section 16(b) Rules require that a plan be "established" or approved by disinterested directors. For example, the SEC rules permit the plan to be approved by the entire board of directors, which generally includes several directors who do not qualify as disinterested. The New and the Old SEC Section 16(b) Rules merely require that the plan, once adopted, be administered by disinterested directors.

Thus, for example, if a plan were adopted by the entire board of directors (other than a mere board ratification of a plan adopted by a disinterested compensation committee) and the board of directors contained one or more directors who did not qualify as disinterested, the plan is apparently not "established" by disinterested directors (even though it is administered by disinterested directors) and hence it apparently does not qualify for the special transitional rule, if literally read.

It appears that the IRS did not intend the transitional rule to be this narrow. The regulatory preamble states that the transitional rule is "provided for a plan that meets both the disinterested director and shareholder approval requirements of Rule 16b-3 . . . as of the date of the publication of these regulations"[159] suggesting that IRS may have thought, incorrectly, that there was an SEC requirement that disinterested directors establish a plan. Treasury officials have indicated that, for purposes of the transitional rule, the final regulations will not require disinterested directors to establish such a plan.[160]

[159]58 *Fed. Reg.* at 66,313.

[160]The authors understand, however, that for plans approved by shareholders on or after December 20, 1993, the IRS intends to continue the proposed regulation's requirement that the compensation committee "establish" the plan. *See* prop. reg. section 1.162-27(c)(4).

B. Postponement of Outside Director Definition

The proposed regulations state an important transitional rule treating as a qualified "outside director" any person who is a "disinterested director" for SEC purposes (under the New or Old SEC Section 16(b) Rules) until the corporation's first election of directors that occurs after July 1, 1994.[161] This relief allows a corporation to establish plans or set performance goals in compliance with the performance-based-compensation exception at a time when the corporation does not have a compensation committee composed solely of outside directors within the meaning of section 162(m).[162]

IV. Other Issues

A. Application to Publicly Traded Partnerships

Section 7704(a) generally causes a "publicly traded partnership" (a PTP) to be treated as a corporation "for purposes of this title." Certain PTPs in existence when section 7704 was adopted by the 1987 Tax Act and that do not otherwise qualify for the section 7704(c) exception were grandfathered for 10 years, until their first taxable year beginning after December 31, 1997.[163]

> ***It is not entirely clear whether section 162(m) will apply to a PTP that is treated as a corporation under section 7704.***

It is not entirely clear whether section 162(m) will apply to a PTP that is treated as a corporation under section 7704 (a PTP-corporation). It would appear that a PTP-corporation would be covered by section 162(m) because (1) section 7704 states that a PTP-corporation is a corporation "for purposes of this title" and this title includes section 162(m)[164] and (2) a PTP is required to register its common equity securities under section 12 of the 1934 act.

However, the preamble to the proposed regulations states:

> Questions have arisen as to the application of section 162(m) to certain master limited partnerships whose equity interests are required to be registered under the [1934 act] and that, beginning in 1997, may be treated as corporations for Federal income tax purposes. 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 ex-

[161]Prop. reg. section 1.162-27(h)(2). The definition of "disinterested director" for SEC purposes is described in footnote i158. above.

[162]*See* prop. reg. section 1.162-27(e)(3).

[163]1987 Tax Act, Pub. L. No. 100-203, section 10211(c), as amended by Pub. L. No. 100-647, section 2004(f)(2).

[164]The golden parachute regulations state that, for purposes of section 280G, a corporation shall include a corporation as defined in section 7701(a)(3) (i.e., an association taxable as a corporation) and a PTP treated as a corporation under section 7704(a). Prop. reg. section 1.280G-1, Q&A 45.

ception for performance-based compensation is currently under study and is not addressed in these proposed regulations.[165]

If PTP-corporations were to be treated as publicly traded corporations for purposes of section 162(m), it is unclear how various provisions of the proposed regulations would apply.

- Who are a PTP-corporation's covered employees? An executive who acts solely as a general partner would generally not be an employee at all. Moreover, a PTP-corporation may not file a proxy statement disclosing executive compensation (given that it may not need to seek the approval of its public limited partners for such compensation).[166]
- What would constitute shareholder approval of a plan for purposes of the performance-based-compensation exception (see II.E.3. above) since a PTP has no shareholders and its public partners generally are limited partners?
- How would a compensation committee be formed since a partnership need not have a board of directors?
- Could Exception #2 for pre-IPO plans and agreements apply since the exception literally applies only to a "*corporation* that was not publicly held" (emphasis added)?[167] Literally read, Exception #2 would not apply to a plan or agreement adopted by a partnership prior to becoming a PTP-corporation because such a partnership (which becomes a PTP-corporation) is not a "corporation" at the time it adopts the pre-IPO plan or agreement.

Moreover, where a PTP begins to be taxed as a corporation as a result of the expiration of section 7704's 10-year grandfather rule, the PTP-corporation will generally not need to issue a prospectus to its shareholders (since it will not be issuing new securities to its shareholders). Thus, there will be no prospectus in which to make the disclosure necessary to satisfy Exception #2.

The authors believe that the regulations, when finalized, should expand Exception #2 to exempt compensation arrangements entered into by any entity (whether or not it is then treated for tax purposes as a corporation) prior to its becoming a publicly held corporation, even though such a partnership (which becomes a PTP-corporation) is not a "corporation" at the time it adopts the pre-IPO plan or agreement.

[165]58 *Fed. Reg.* at 66,311.

[166]If a PTP-corporation does not file a proxy statement, it is required to include a summary compensation table disclosing executive compensation as part of its Form 10-K filed with the SEC (and available to the public). As noted in II.D.1. above, it is not clear whether disclosure in a Form 10-K is sufficient to make a person a covered employee (on the ground that the Form 10-K is not mailed directly to shareholders and hence may not be "reported to shareholders.")

[167]Prop. reg. section 1.162-27(f).

B. Section 83(b) Elections

There may be a technical problem under the performance-based-compensation exception where (1) an executive of a publicly held corporation receives a grant of restricted stock, (2) the restrictions on the stock require that the executive attain an objective preestablished performance goal in order to retain the stock, and (3) the executive makes a section 83(b) election to be taxed on the receipt of the stock rather than on its vesting.[168] In such case, the executive immediately recognizes ordinary compensation income equal to the difference between the fair market value of the stock at the time of grant and the amount paid for the stock, and the corporation would normally receive a corresponding deduction. However, by accelerating both the executive's income and the corporation's deduction, the section 83(b) election causes the corporation's deduction to occur before the performance goals can be met (and hence also before the compensation committee can certify that they are met). See II.E.1. and II.E.4. above. Thus, it is not clear whether the corporation can rely on the performance-based-compensation exception in such case, even if the performance goals are ultimately met.

The regulatory preamble states that the "proposed regulations do not address this issue and comments are specifically requested."[169] The authors believe that the final regulations should clarify that, assuming the award would otherwise qualify for the performance-based-compensation exception, a section 83(b) election does not prevent reliance on such exception.[170]

The statute (and proposed regulations) require that the compensation committee certify that the performance goals are met before the payment of the compensation.[171] Although a section 83(b) election alters the timing of the employee's income and the corporation's deduction, the election does not alter the economic reality of when the employee receives payment. Even if an employee makes a section 83(b) election, the stock is still subject to a substantial risk of forfeiture until the performance goal is attained. Thus, in an economic sense, payment does not occur until the performance goal is met and the stock vests. While the corporation may take the deduction before the

[168]In many cases, the executive will be not want to make a section 83(b) election. If the executive pays nothing for the restricted stock, 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 restricted stock without payment 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 that would further increase the executive's gross income).

[169]58 *Fed. Reg.* at 66,313.

[170]*Compare* the section 280G proposed regulations that ignore the 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).

[171]*See* section 162(m)(4)(C)(iii); prop. reg. section 1.162-27(e)(5).

compensation committee's certification, the payment of compensation would not occur until after certification and vesting.

This result is consistent with the section 83 rule that if an employee later forfeits restricted stock, the employer must include in income for the forfeiture year the amount the employer previously deducted as compensation in the grant year.[172] Thus, if the employee fails to satisfy the objective performance goals, the employer loses the economic benefit of the deduction under both section 83 and section 162(m) because the employer must take into income in the forfeiture year an amount equal to the employer's deduction in the grant year.

The authors believe that section 162(m) is an unwise exercise in political and social engineering and an embodiment of manifestly unsound tax policy.

Of course, if the corporation allowed the employee to retain the stock although the performance goals were not met, the employer should similarly lose the economic benefit of the deduction under section 162(m), even though not required by section 83. This logical result could be achieved by requiring the employer to report income in the year the performance goal was failed equal to its grant year deduction (just as the section 83 regulations would require where the property is forfeited). The alternative approach of requiring the employer to amend its grant year return to eliminate the deduction (rather than reporting income in the later year equal to the earlier deduction) is a far less desirable approach due to its administrative and practical difficulties (e.g., statute of limitations).

C. Relinquishment of Discretionary Power

As discussed in III.A. above, the proposed regulations provide a transitional rule for plans that were approved by shareholders prior to December 20, 1993. This transitional rule relaxes the outside director requirement (see II.E.2 above) and shareholder approval requirement (see II.E.3. above), but still maintains the nondiscretionary performance goal requirement (see II.E.1. above).

Many plans that otherwise would qualify under the transitional rule will not qualify because the compensation committee and/or board of directors have the discretionary power to increase awards under the plan. The authors believe that the transitional rule should be expanded to cover a plan that otherwise qualifies under the transitional rule if the compensation committee and board of directors relinquishes all power to increase an award under the plan by a specified date.

V. Conclusion

The authors believe that section 162(m) is an unwise exercise in political and social engineering and an embodiment of manifestly unsound tax policy. As such, section 162(m) deserves the quick repeal which, unfortunately, it is not likely to receive.

First, section 162(m) makes an irrational distinction — imposing the compensation deduction limit on remuneration to a corporate executive of a publicly held corporation but not (e.g.) to an athlete or a thespian.

Second, there is no more rational tax-policy reason for imposing a deduction limit on executive compensation than on advertising, research, marketing, or other expenditures.

Third, even more important, section 162(m) has created a tremendous, and senseless, time burden on U.S. publicly held companies. As amply demonstrated in the discussion in I. through IV. above, the section 162(m) rules (even had they contained no ambiguities) would place a substantial and unnecessary burden on publicly held corporations (e.g., creating and administering complex and formulistic compensation plans, obtaining legal advice on whether particular plans comply with section 162(m), and ascertaining which old plans are grandfathered).

Moreover, the section 162(m) rules are not free from ambiguity. Hence, a significant (and expanding) amount of time is being spent by lawyers, accountants, compensation consultants, and busy executives debating the obscure and unproductive, but tax important, nuances of section 162(m). This burgeoning time and cost drain on U.S. industry is directly counter to our important national goal of increasing productivity and competitiveness.

Finally, by forcing much of U.S. industry to adopt rigid and unalterable bonus formulas at least a year in advance, section 162(m) will inevitably cause some executives to receive unduly generous compensation while others receive inappropriately smaller compensation when the corporation's financial results take an unexpected turn.

Although the proposed regulations take a reasonable (and occasionally even a pro-taxpayer) position on many issues, there are several key points where the proposed regulations are terribly ambiguous, harsh, or unworkable.

In light of the above, 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. However, a November 1993 SEC policy requires that the compensation committee's report disclose how section 162(m) will be taken into account in setting executive compensation. Thus, even where the value of the lost deductions is not material to the corporation's finances, a public corporation may find it unpleasant to report that the compensation to be paid one or more of its top executives will not be deductible in full.

[172]Reg. section 1.83-6(c).