REPORT #783

TAX SECTION

New York State Bar Association

Comments on Proposed Regulations under Section 162(m)-the $1 Million Limitation on Deductible Compensation

March 4, 1994

Table of Contents

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Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

Re: Section 162(m) Regulations

Dear Secretary Samuels and Commissioner Richardson:

Enclosed are copies of a Report by the New York State Bar Association Tax Section on the proposed regulations under section 162(m) of the Internal Revenue Code, relating to the $1 million limitation on the deduction of compensation paid to certain employees of public corporations.

The Report commends the Treasury Department and the Internal Revenue Service for their timely issuance of the proposed regulations and their creative and helpful approach to many of the difficult issues posed by the underlying legislation. The Report states that the proposals represent an excellent first step towards creating a framework for the fair administration of the legislation.

The Report goes on to suggest a number of clarifications and modifications to the regulations designed to make them in certain respects less burdensome and more consistent with established corporate practice, while still consistent with the intent of the statute. For example, the Report suggests that:

(i) the three-month rule in Notice 94-2, permitting performance goals to be established after the beginning of the performance period, should be made permanent;

(ii) consideration should be given to eliminating the requirement that satisfaction of a performance goal be “substantially uncertain” at the time the goal is set, and substituting (x) a rule that a performance goal will not qualify if it is a subterfuge for the payment of nonperformance based compensation and (y) an irrebuttable presumption that a subterfuge would exist if the outcome was substantially certain at the time the goal was set;

(iii) the definition of “outside director” should be broadened by deleting the $60,000 threshold now in the proposed regulations;

(iv) rules reflecting ordinary corporate practice should be adopted to deal with such issues as stock dividends, extraordinary corporate transactions and events, earnings on deferred performance-based compensation, normal salary increases, and spin-offs of subsidiaries of public corporations; and

(v) a number of liberalizations should be made in the transition rules.

Please feel free to let me know if we can be of further help in the development of the final regulations.

Very truly yours,

Michael L. Schler
Chair

cc: Randolf H. Hardock
J. Mark Iwry
Charles Deliee
Robert Misner

NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMITTEE ON NONQUALIFIED EMPLOYEE BENEFITS
AND COMMITTEE ON QUALIFIED PLANS

Comments on Proposed Regulations under Section 162(m)-the $1 Million Limitation on Deductible Compensation[1]

March 4, 1994

The purpose of this Report is to provide comments with respect to the Proposed Regulations under Section 162(m) of the Internal Revenue Code of 1986.[2] Before commenting on specific provisions of the Proposed Regulations, however, the Committee would like to commend the Treasury and Internal Revenue Service for their timely issuance of the Proposed Regulations and their creative and helpful approach to many of the difficult issues posed by the underlying legislation. While the Committee remains philosophically opposed to the regulation of executive compensation through tax legislation of this nature[3], the

[1] This Report was written by Stuart N. Alperin and Kenneth C. Edgar, Jr. (co-chairs of the Committee on Qualified Plans), and Stephen T. Lindo and Loran T. Thompson (co-chairs of the Committee on Nonqualified Employee Benefits (collectively with the Committee on Qualified Plans, the “Committee”)), Adam D. Chinn, Brian T. Foley and James P. Lawton. Helpful comments were also received from Richard J. Hiegel, Carolyn Joy Lee, Richard O. Loengard, Jr., Stephen L. Millman, Richard L. Reinhold and Michael L. Schler.

[2] All section references in this Report are to the Internal Revenue Code of 1986, as amended by the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66), unless otherwise indicated.

[3] See “Report on Certain Compensation-Related Provisions of H. R. 2141”, dated June 10, 1993.

Proposed Regulations represent an excellent first step toward creating a regulatory framework in which the legislation can be fairly administered. This Report will identify areas in which the Committee believes the Proposed Regulations should be altered or further clarified in order to achieve that result.

1. Definition of Covered Employees (§1.162-27(c)(2)(i)).

The preamble makes clear the drafters' intent that an individual must be employed as an executive officer on the last day of the taxable year to be a "covered employee." To make the regulations explicit on this point, the Committee recommends inserting, after the word "is" in the lead-in clause of Proposed Regulations §1.162-27(c)(2)(i), the phrase "employed by the corporation and is."

2. Definition of Compensation Committee (§1.162-27(c)(4)).

The Proposed Regulations' definition of "compensation committee" requires that the committee have authority to "establish and administer" a performance-based compensation arrangement. We are concerned that this language could be read to require that the committee must have authority "to establish" a plan. Normally, a compensation committee would recommend a compensation plan, but the compensation plan would be "established" by the board of directors, subject, where applicable, to shareholder approval.[4] We believe that it is sufficient for purposes of Section 162(m) that the Committee have authority "to administer" compensation arrangements; i.e. what is important is that the compensation committee establish and administer the performance goals as opposed to establishing the

[4] E.g., due to the provisions of Section 16(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act").

plan under which the goals are articulated. We therefore suggest that the first sentence of §1.162-27(c)(4), in relevant part, be amended to read as follows:

> "The compensation committee means the committee of directors (including any subcommittee of directors) of the publicly held corporation that has the authority to establish <u>the performance goals</u> and administer a performance-based compensation arrangement...."

In addition, in the second sentence of the definition, there is very helpful language to the effect that the compensation committee is not treated as failing to have the authority to <u>establish</u> a performance-based compensation arrangement because the arrangement is ratified by the board of directors of the publicly-held corporation or any other Committee of the board of directors. For the reasons stated above the committee believes that the sentence should be changed in relevant part to read as follows:

> "A committee of directors is not treated as failing to have the authority to establish <u>performance goals or administer</u> a performance-based compensation arrangement merely because <u>the actions of the committee relating to such establishment or administration are subject to ratification</u> by the board of directors of the publicly held corporation or, if applicable, any other committee of the board of directors <u>or the shareholders of the publicly held corporation</u>."

Under this approach if a compensation committee makes a grant of an option which is subject to ratification by another committee of the board (e.g., an expanded compensation committee) which contains individuals who, although "disinterested" for purposes of Section 16(b) of the Exchange Act, do not qualify as outside directors under the restrictive definition contained in the proposed regulations, the grant can still qualify as "performance-based".

3. Performance Goal Requirement: Preestablished Goals (§1.162-27(e)(2)(i)).

a. Deadline for Establishing Goals. The Proposed Regulations require that a performance goal be established before the first day of the corporation's fiscal year (in the case of a performance-based compensation program based on services rendered during the entire fiscal year). Proposed Regulations §1.162-27(e)(2)(i). The transition rule set forth in Notice 94-2 deems this requirement to be satisfied if the compensation committee establishes the performance goal before April 1, 1994 (provided that, at the time the compensation committee establishes the goal, the outcome of the goal is substantially uncertain and the period of services to which the goal relates does not begin before January 1, 1994 and is scheduled to continue for at least nine months).

Many, if not most, compensation committees now rely in part on company-wide, business unit and other year-end performance data for the most recent fiscal year in setting the goals for the annual bonus plan and other incentive plans for the current year, which is usually done within the first 30-75 days of the new year. As a result, compliance with the Proposed Regulations' requirement generally will force compensation committees to establish performance goals in a partial vacuum because they will not yet have available the prior year's financial or other performance-based results. The Committee believes that the establishment of goals based on such incomplete information will not serve the best interest of the corporation or its shareholders. Furthermore, it is the Committee's view that the three-month period allowed in Notice 94-2 protects the integrity of the preestablished-goal requirement where there are at least nine months remaining in the performance period.

Accordingly, the Committee recommends modifying the regulations to permit the compensation committee to establish the performance goal within three months after the commencement of the fiscal year or other period to which the performance goal relates, provided that the period of services to which the goal relates is scheduled to continue for at least nine months. For the reasons discussed below, the Committee also believes consideration should be given to revising the substantially-uncertain requirement contained in Notice 94-2 and the Proposed Regulations. It is our view that whether or not the substantially uncertain test is revised, as discussed below, the mere fact that the compensation committee waits three months into the fiscal year to establish the performance goals should not itself cause such goals to run afoul of the applicable anti-abuse rules adopted in the final regulations.

b. "Substantially Uncertain" Requirement. Section 1.162-27(e)(2)(i) of the Proposed Regulations imposes a requirement that performance goals be established while the outcome of the goals is "substantially uncertain." The Committee recognizes the need for an anti-abuse provision to prevent disguising fixed compensation as performance-based through the use of unrealistically low performance goals. However, the Committee is concerned that the "substantially uncertain" formulation may be overbroad and could give rise to unnecessary controversies as to the qualification of corporations' performance-based programs. Given the vagueness of the standard and inherently factual nature of the question, it may be difficult for a taxpayer to meet the burden of proof in establishing that a goal was substantially uncertain when established by the compensation committee. The Committee is also concerned that the substantially uncertain test, when used in conjunction with the "contingent upon attainment" requirement of

Section 1.162-27(e)(2)(iv), will lead to complete nondeductibility, where only a tiny fraction of the overall goal might be shown not to have been substantially uncertain when established.

For example, if a bonus pool is created consisting of a designated percentage of profits, and the corporate employer has been consistently profitable in the past, is it “substantially uncertain” that a bonus will be paid for the year? Whether or not the goal of profitability is substantially uncertain, so long as the bonus pool grows as the corporation generates more profits (subject, for example, to a maximum bonus payable to any individual) the compensation is clearly linked to performance and should, in our view, be deductible.

To address these concerns and to make the interpretation of the term “performance-based compensation” more predictable, the Committee believes that consideration should be given to the elimination of the “substantially uncertain” requirement and substitution of the requirement that a performance goal will not qualify if it is merely a subterfuge for the payment of compensation that in reality is not linked to performance. For this purpose, a “performance goal” would irrebuttably be deemed to be a subterfuge if it were “substantially certain” in advance that the “outcome” contemplated by the performance goal would be attained. The taxpayer would not fall within the “substantially certain” standard if it could demonstrate that a realistic possibility existed at the time the performance goal was set that the “contingent compensation” would not be paid.

Of course, the general subterfuge test would still be available to the Service, even if the taxpayer overcame the “substantially certain” test. An example of a subterfuge would be a disguised minimum bonus, which might be evidenced by a precipitous drop in the percentage of sales or profits payable as compensation once sales or profits exceeded a threshold very likely to be met. On the other hand, it is intended that a performance goal consisting of a reasonable formula based on profits or sales would not be considered a subterfuge merely because it was substantially certain that a relatively small portion of the performance based compensation would be paid (e.g., because it was substantially certain that there would be some profits or sales for the year, even though the absolute level was uncertain).

By way of further illustration, if a manufacturer adopts a bonus program providing for a minimum bonus if sales for the fiscal year attain at least a level corresponding to 5% of the prior year's sales, ordinarily bonuses paid under the program would not constitute qualified performance-based compensation. On the other hand, if a bonus program provides for the payment of bonuses keyed in amount to pre-established percentages of net profits, where the formula results in a reasonable increase in bonus payments as profits increase, bonuses paid under the program generally would qualify as performance-based compensation provided the other requirements of the regulations are met.

The Committee acknowledges that there is no perfect solution to the problems discussed herein and there will be some uncertainty in application regardless of the rule finally adopted. We note that while the “substantially certain” portion of our proposed test would be easier for taxpayers to satisfy than the test in the Proposed Regulations, we believe the Government's interests are adequately protected through our overriding “subterfuge” test. The Committee further believes that its proposal may strike a better balance than the Proposed

Regulations in reducing uncertainty about the permissibility of ordinary nonabusive compensation arrangements while at the same time preventing abusive arrangements. The proposal is also consistent with a number of other recent regulations that contain general anti-abuse tests.[5]

4. Impact of Corporate Transactions and Other Extraordinary Events (§1.162-27(e)(2)(vi)(C)).

The Committee believes that the relief provided by §1.162-27(e)(2)(vi)(C) with respect to award adjustments for corporate transactions affecting stock options and stock appreciation rights should be expanded:

- to refer to stock dividends as well as stock splits; and
- more importantly, to permit the adjustment of any other stock-based compensation awards (e.g. phantom stock) that otherwise qualify as performance-based to take into account the types of transactions listed in paragraph (e)(2)(vi)(C).

The Committee also notes that many companies will need to consider whether and how to restructure existing plan provisions permitting compensation committees discretion to adjust the amounts payable under certain cash-based and stock-based annual and long-term incentive plans to address the possible hardship and windfall aspects of extraordinary events. In particular, since only “negative discretion” is permitted under the regulations, consideration will need to be given to whether and how to tighten the definitions used in setting performance goals, e.g., to exclude the impact of accounting rule changes and certain extraordinary charges.

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5 See, e.g., Temp. Reg. § 1.1275-2T; Reg. § 1.704-3 (a)(10).

In this connection, the Committee believes it would be helpful to provide that a formula's exclusion of the impact of extraordinary events and/or restructuring charges, including but not limited to those extraordinary events which are reflected in financial statements prepared by the company's outside accountants, would be permissible. In addition, under this rule the compensation committee should, in the reasonable exercise of its discretion after the beginning of the applicable performance period, be permitted to determine which events or changes qualified as "extraordinary" and were thus excludable from the final bonus calculations. This suggestion is made because it may be impossible for the compensation committee to enumerate in advance all potential extraordinary events.

5. <u>"Fruit of the Tree" Aspects of Performance-Based Compensation §1.162-27(e)(2)(iii)</u>.

The Committee believes that §1.162-27(e)(2)(iii) should be revised to clarify that, in the case of earned performance-based compensation that has been deferred (i) any actual or deemed interest, dividend, or other income adjustment made pursuant to the terms of the plan after the performance period, and (ii) any appreciation or other equivalent value adjustments made after a performance period in the principal amounts payable under a plan, will be deemed to also constitute performance-based compensation.

The Committee believes that such a result makes sense, provided that there is an anti-abuse rule to deal with situations where the amounts of the income or value adjustment do not bear a rational relationship to the underlying investment vehicle, or the underlying investment vehicle is a deemed one that does not have a “real life” equivalent and provides excessive income or value adjustments.

Thus, for example, where payout of shares of stock or equivalent units, once earned, is deferred, the dividends or dividend equivalents on such shares and any pre-payout appreciation should qualify as performance-based so long as the original award so qualified. Likewise, under a cash bonus plan where the participants' bonuses are deferred and hypothetically invested in a portfolio of investments the income on and appreciation (or depreciation) in the value of such awards should qualify as performance-based so long as the original award so qualified.

However, where a performance-based award has been earned and is then deferred with deemed interest at a rate that is well above market and does not reflect the returns (and risks) of any available “real life” investment vehicle, e.g., is credited at a rate equal to twice the prime rate with no downside risk on the principal, the Service could treat such hypothetical rate of return as abusive and treat such interest when paid as non-performance-based compensation.

6. <u>Discretion (§1.l62-27(e)(2)(iii))</u>.

While the Committee agrees with the approach of the Proposed Regulations with respect to precluding discretion to increase the compensation payable upon the attainment of a performance goal, the Committee is concerned that this standard may present a trap for the unwary. Most annual and long-term cash bonus plans define their awards in terms of a percentage of an employee's base salary during or at the end of the applicable performance period. We are concerned that under the Proposed Regulations the ability of the compensation committee to increase an employee's base salary during the course of the year constitutes impermissible discretion to increase the compensation payable upon attainment of a goal.

The Committee believes that it is appropriate to permit a compensation committee to increase, during the applicable performance period, the compensation payable upon attainment of a performance goal under a salary-based bonus plan where salary is increased during the performance period in the ordinary course of business consistent with a company's past practice or as a result of a bona fide promotional increase. Accordingly, the Committee believes that a new sentence should be added to §1.162-27(e)(2)(iii)(A) after the first sentence to read as follows:

> "An objective formula or standard will be deemed to preclude discretion to increase the amount of compensation that would otherwise be due upon attainment of a goal where the objective formula or standard contains as one of its components the amount of an employee's base salary at, or at some time after, the commencement of the performance period, provided that any increases in base salary after the commencement of the performance period are made in the ordinary course of business consistent with past practice or are bona fide promotional increases."

7. Outside Directors (§1.162-27(e)(3)).

The Committee believes that the definition of an "outside director" in Proposed Regulations §1.162-27(e)(3) is much too narrow and will have the effect of rendering ineligible to serve as outside directors a number of qualified and disinterested directors. The most problematic exclusion from the definition of an outside director is caused by the definition of "de minimis remuneration" for purposes of paragraph (e)(3)(ii).

The $60,000 limitation on the provision of goods or services by an entity “by which the director is employed (including self-employed)” has the effect of disqualifying, in many cases, any employee of any telephone company, local utility, bank and many other major U.S. businesses. From a policy standpoint, it seems unlikely that a director who works for a company with billions of dollars of gross income is likely to be subject to significant undue influence merely because his or her employer receives over $60,000 of fee income from a company on whose board he or she sits. The regulation also goes far beyond the Conference Committee Report's concept of disqualifying directors receiving “compensation for personal services”.

The Committee recommends that the Proposed Regulations be amended to delete the $60,000 threshold and define “de minimis remuneration” as a specified percentage (e.g. 5%) of the gross income of the entity employing the director or in which the director has a more than 5% (but less than some designated percentage) beneficial ownership interest. Not only is this consistent with SEC disclosure requirements under Item 404 (b)(4) of Regulation S-K but it will also avoid disqualification of directors whose employers receive immaterial amounts from the companies on whose boards their employees sit. In order to assuage concerns about service-oriented firms, a lower percentage of gross income thresholds might be appropriate for lawyers, investment bankers, consultants and similar professionals.

Finally, the Committee believes that the Proposed Regulations should make it clear that a director is not self-employed with respect to any entity merely because he or she is an outside director of that entity. For example, a director of Company A and B, who has no other relationship with those companies, should not be disqualified as an outside director of

Company A because Company A pays more than de minimis remuneration to Company B.

8. Shareholder Approval Issues (§1.162-27(e)(4)).

a. Disclosure of maximum amount or performance formula. To avoid undue confusion, the Committee believes that clarification is needed in §1.162-27(e)(4)(i) regarding the intended scope and operation of the requirement that the company disclose either:

> "the maximum amount of the compensation to be paid or the formula used to calculate the amount of compensation if the performance goal is attained".

In particular, the Committee suggests that the disclosure requirements of §1.162-27(e)(4)(i) be modified to further clarify and reinforce the following points:

(1) the "maximum amount of the compensation to be paid" is intended to refer to the maximum amount payable to any named executive versus the top five executives or the entire plan population as a group; and

(2) the maximum amount need not be expressed as a dollar amount if it is otherwise stated as an objective formula, the elements of which cannot be changed to the executive's benefit (other than as discussed in paragraph 6, supra.) without shareholder approval.

The Committee is concerned, with respect to point (2) above, that the language of 1.162-27(e)(4)(iv), which reads "If the terms of the performance goal do not provide for a maximum dollar amount, the disclosure must include the formula under which the compensation would be calculated" [emphasis added] implies that a company must specify to its shareholders either a dollar maximum (as opposed to a maximum amount derived by formula) or the actual formula used to calculate the performance-based compensation. The Committee believes that it should be permissible to specify a maximum amount of compensation based on a formula. For example, it should be permissible to specify a maximum award based on a designated percentage of a corporation's profits, whether the actual award is based on profits or some other performance goal.

To implement its recommendations, the Committee suggests that §1.162-27(e)(4)(i) and (iv) be modified as set forth below. The last clause of §1.162-27(e)(4)(i) would be amended to replace “to be paid” with “payable to any individual” and to add the word “such” before “compensation” the second time it appears in the clause.

The second sentence of §1.162-27(e)(4)(iv) would be amended and a new third sentence added, as follows:

> If the terms of the performance goal do not provide for a maximum dollar amount payable to any individual or a formula under which shareholders can calculate such maximum amount payable the disclosure must include the actual formula under which the compensation would be calculated. Except as otherwise provided in these Regulations, elements of such maximum or actual formula which are within the discretionary control of the corporation must be disclosed to shareholders and, once approved, cannot be changed to the individual's benefit without subsequent shareholder approval.

b. Disclosure of all material terms.

The last sentence of Proposed Regulations §1.162-27(e)(4)(i) states that the “material terms” required to be disclosed “include” (and therefore may not be limited to) the three items covered in that sentence (i.e. class of employees covered, description of business criteria and description of maximum per person amount of bonus formula).

The Committee feels that such open-endedness could lead to inadvertent technical failures in obtaining shareholder approval. It therefore suggests that the material terms should “consist of”, rather than “include”, the items specified in that sentence. As currently provided in the Proposed Regulations (§1.162-27(e)(4)(v)), SEC disclosure rules would apply in determining whether such material terms were adequately disclosed.

c. Example.

The Committee also suggests that the following additional example be added to Proposed Regulations §1.162-27(e)(4)(viii):

Example 6

> Corporation W establishes a cash bonus plan for its executive officer group under which a bonus pool is generated each year based on a target of 5% of net income in excess of the first $10 million, with the percentage stepping up to 10% for net income in excess of $30 million and 15% for net income in excess of $50 million. The pool is allocated based on units assigned at the start of each year, and no individual can be assigned more than 10% of the units, or earn more than $500,000 per year.
>
> Under these facts, the requirements of this paragraph (e)(4) would be satisfied if the company disclosed to shareholders that (i) all executive officers are eligible to participate, (ii) the bonus formula is based on a percentage of net income in excess of a designated threshold, and (iii) the maximum amount payable under the plan to any one individual is $500,000.

9. Public Offering of Private Corporation Stock (§1.162-27(f)).

We agree with the approach taken in the Proposed Regulations, which provide that the $1 million cap “does not apply to any compensation plan or agreement that existed during the period in which the corporation was not publicly-held”.

However, the Committee feels that the provisions of this exemption need to be refined further.

The first clause of §1.162-27(f), which limits the application of this exemption to corporations that “were not publicly-held for the entire taxable year”, arguably makes the exemption inapplicable to any full year occurring after the corporation became a public company. This ambiguity should be resolved by making it clear, as stated in the preamble to the Proposed Regulations, that compensation paid under plans or arrangements that were in existence when the corporation became publicly traded is (subject to our discussion below) permanently exempt from Section 162(m).

The Committee believes, however, that after a corporation has been public for five years, it should be required to obtain shareholder approval and to meet all other applicable requirements of Section 162(m), with respect to all future grants or awards under plans and arrangements adopted during the period in which it was a private company. Amounts awarded or accrued prior to the end of the five year period would, of course, continue to be exempt. This rule seeks to avoid the potential abuse of private companies adopting substantial long-term plans in contemplation of an IPO in order to take undue advantage of the exclusion.

The privately-held company exclusion only covers plans or arrangements which are disclosed in a manner “that satisfied all applicable securities laws then in effect.” The question arises, for example, whether, the exclusion would cover compensation paid under an employment contract which covers an officer of a private corporation which is going public if such officer is not among the top five officers required to be disclosed in the registration statement, but later became one of the top five officers of the now publicly-held corporation and continued to be covered under the same employment contract. The Committee's view is that so long as the disclosure rules prescribed by the SEC are satisfied, all plans and arrangements, including undisclosed plans and arrangements, are protected by the exclusion.

A serious problem exists with respect to privately- held subsidiaries of public companies which become publicly-held due to a public offering of their stock or a spin-off transaction. The problem arises because, by application of affiliated group rules, such private subsidiaries may be considered to be publicly-held. The Committee would address this issue by extending to such subsidiaries the protective rules of the exemption because it cannot be reasonably expected that such subsidiaries would have been operated in a manner which met Section 162(m) prior to their becoming public companies, other than with respect to officers of subsidiaries who are named executives of their parent corporations.

Failure to adopt the rule would put spun off companies at an unwarranted disadvantage with respect to executive compensation. Prior to the spinoff transaction, officers of the subsidiary will normally receive options (at the spinoff value) pursuant to a newly-adopted option plan and will be participants in bonus programs which will pay out depending on the performance of the subsidiary. As a practical matter such plans are not presented for approval to the shareholders of the public parent company because no such shareholder approval is required and because the timing of the spinoff would have to coincide fortuitously with a shareholder annual meeting in order for appropriate materials to be available to be presented to the public shareholders. In addition, if the IPO exception were inapplicable to spinoffs, deferred bonuses or other awards previously granted to such officers would become subject to Section 162(m) for no compelling policy reason.

To take account of the concerns noted above, the Committee suggests that the first sentence of Proposed Regulation §1.162-27(f) be modified to read as follows:

> "In the case of a corporation that was not publicly held for a portion of the taxable year or a portion of any prior taxable year, without regard to the affiliated group rule of Section 1.162-27(c)(1)(ii), the deduction limit of paragraph (b) of this section will not, for a period commencing on the date on which the corporation became publicly held and ending on the fifth anniversary of the end of the taxable year in which the corporation became publicly held, apply to compensation paid or awarded to any employee (other than a covered employee (taking into account the affiliated group rules) for the fiscal year immediately preceding the year in which the corporation became publicly held) under any compensation plan or agreement that existed during the period in which the corporation was not publicly held, if the prospectus accompanying the initial public offering, or the other required disclosure document distributed in connection with the corporate transaction in which the corporation became publicly held, disclosed information concerning those plans or agreements that satisfied all applicable securities laws then in effect."

10. Material Modifications of Agreements in Effect on February 17, 1993 (§ 1.162-27(h)(1)).

The Committee believes that the concept of a material modification set forth in § 1.162-27(h)(1)(iii)(A) and (C) is too broad when applied to future increases in compensation, and, if left unchanged, would as a practical matter substantially eliminate the grandfather protection that was intended to be provided.

Specifically, if an agreement in effect on February 17, 1993 expressly contemplated discretionary compensation in addition to fixed compensation, the Committee believes that paragraph (h)(1)(iii)(A) and (C) should be modified to provide that the payment of that discretionary compensation, while itself not grandfathered, should not taint fixed compensation that otherwise qualifies for grandfathered treatment, even if it is paid on the same basis.

To illustrate, if an executive entered into an employment contract on January 1, 1991 which provided for a salary of $600,000, subject to “such increases as the board of directors may thereafter approve from time to time” and the board in June of 1993 granted a discretionary raise of $45,000 (which exceeded a mere cost-of-living increase), the entire contract would, under the Proposed Regulations section cited above, arguably no longer be grandfathered. See §1.162-27(h)(1)(iv), Example 2. A fairer application of the law would be to continue to grandfather the contract as to the base salary in effect on February 17, 1993 and only treat the increase in salary as not being grandfathered. The basis for the Committee's view is that if an otherwise grandfathered contract explicitly contemplates a discretionary increase in compensation, the entire contract should not be tainted by such increase since it was clearly contemplated by the parties in the original grandfathered contract. The discretionary portion would, of course, be subject to the $1 million cap unless it was itself performance-based. If Treasury and the Internal Revenue Service are not in agreement with this analysis, a significant problem could arise with respect to contracts which were otherwise grandfathered but under which, prior to the enactment of Section 162(m) or the issuance of proposed regulations, a discretionary salary increase (not protected by the “cost of living” rule) or a discretionary bonus was paid which would “taint” the entire contract.

To further illustrate, if an executive entered into an agreement dated November 1, 1992 stating that his or her annual bonus opportunity for 1993 was $500,000, $300,000 of which is guaranteed and $200,000 of which is discretionary, the grandfathered status of the $300,000 of guaranteed bonus should not be adversely affected if the company paid out all or part of the $200,000 balance of target annual bonus opportunity for 1993, even though such additional payment itself is not grandfathered. A contrary result would "ungrandfather" the entire contract.

On the other hand, if the facts are that the annual bonus opportunity referenced in the November 1, 1992 agreement was $300,000 and the company decided to pay an additional $200,000, then, once the $200,000 became payable, all amounts thereafter paid under the contract should not be grandfathered. Of course, if under the last sentence in paragraph (h)(1)(iii)(C), the $200,000 is paid in the form of qualified performance-based compensation, its payment would not constitute a modification. The Committee notes that since all potentially s grandfathered contracts had to have been in place on February 17, 1993, a liberalization of the grandfather rule such as the one presented above is not subject to abuse.

11. Special Transition Rule for Previously Approved Plans (§1.162-27(h)(3)).

a. Grandfather Rule Should Apply on a "Grant" Basis.

On its face, Proposed Regulations §1.162-27(h)(3) is somewhat ambiguous regarding the status of compensation awards which are granted prior to the end of the "reliance period" described in Proposed Regulations §1.162-27(h)(3)(ii) but which are paid following the end of the reliance period. To avoid any possible ambiguity, the Committee believes that it would be helpful to clarify that the transition relief provided under Proposed Regulations §1.162-27(h)(3) applies to any compensation awards granted during the reliance period, regardless of when such compensation is paid.

This could be accomplished by substituting the phrase "attributable to awards granted during the reliance period described below (regardless of when such compensation is paid)" for the term "paid" in the first sentence of Proposed Regulations §1.162-27(h)(3)(i).

b. Establishment of a Grandfathered Plan.

The use of the term "establishing" in the first sentence of Proposed Regulations §1.162-27(h)(3)(i) raises a question regarding the status of a plan which was recommended or approved by a committee of disinterested directors and subsequently approved by the full board, not all of whom may be disinterested directors. Presumably, Proposed Regulations §1.162-27(h)(3)(i) contemplates that the plan must satisfy the "disinterested administration" requirement of Rule 16b-3(c). Such requirement looks to the exercise of discretion by disinterested directors with respect to the administration of the plan, including discretion with respect to all awards granted under the plan, but does not require that only disinterested directors be involved in the initial establishment of the plan.

This issue could be clarified by deleting the phrase "establishing and" in the first sentence of Proposed Regulations §1.162-27(h)(3)(i).

c. Additional Relief For Companies in the Process of Obtaining Shareholder Approval.

Proposed Regulations §1.162-27(h)(3)(i) provides transition relief for plans approved by shareholders prior to December 20, 1993. A number of companies were in the process of seeking shareholder approval for new compensation plans at the time that Proposed Regulations §1.162-27 was issued.

We believe that the transition relief provided under Proposed Regulations §1.162-27(h)(3) should apply to plans which were approved by shareholders prior to December 20, 1993 or which were approved by shareholders after such date based upon proxy material mailed to shareholders prior to January 1, 1994.

d. Cash Award Plans.

Proposed Regulations §1.162-27(h)(3)(i) applies to plans approved by shareholders "in a manner consistent with Rule 16b-3(b), 17 CFR 240.16b-3(b) under the Exchange Act or Rule 16b-3(a), as in effect on April 30, 1991". The use of the phrase "in a manner consistent with" raises a question regarding the status of a plan which was approved by shareholders prior to December 20, 1993 in accordance with the requirements of then applicable state and federal securities laws but which is not subject to the provisions of Rule 16b-3 because the plan only provides for the grant of cash awards which are not considered "derivative securities" under Rule 16a-l(c). We believe that the transition relief provided under Proposed Regulations §1.162-27(h)(3) should extend to such plans.

This issue could be clarified by substituting the phrase "in accordance with applicable state and federal securities laws including, to the extent applicable," for the phrase "in a manner consistent with" in the first sentence of Proposed Regulations §1.162-27(h)(3)(i).

e. Simplification of Reliance Period.

Proposed Regulations §1.162-27(h)(3)(ii) provides that the transition rule provided under paragraph (h)(3) may be relied upon until the earliest of (i) the expiration or material modification of the plan or agreement; (ii) the issuance of all employer stock that has been allocated under the plan; or (iii) the first meeting of shareholders at which directors are to be elected that occurs after December 31, 1996.

There is considerable uncertainty regarding what constitutes the "expiration" of a plan and the "issuance of all employer stock" that has been allocated under the plan. For example, it is not unusual for stock awards to be subject to forfeiture and for any forfeited shares to be available for regrant under the plan. Thus, although such stock may all be "issued", it may later become available for new awards following forfeiture. Similarly, some plans incorporate so-called "evergreen" provisions whereby the maximum number of shares which may be granted during any year is expressed as a percentage of the number of outstanding shares at the beginning of such year. Under such a plan the number of shares available for issuance is automatically replenished each year. The rule also does not address plans which provide for awards in the form of cash rather than stock.

We believe that it is not necessary to attempt to specify when, as a matter of applicable corporate law, awards can no longer be made under a particular plan. That is, once awards can no longer be made, it does not matter whether the reliance period ends then or at the first shareholders meeting that occurs after December 31, 1996.[6]

Accordingly, we believe that the term of the reliance period should be revised to delete the references to "expiration" and "issuance of all employer stock that has been allocated under the plan". As so revised, the reliance period provided under Proposed Regulations §1.162-27(h)(3)(ii) would end on the earlier of (i) a material modification of the plan or (ii) the first meeting of shareholders at which directors are to be elected that occurs after December 31, 1996. This suggestion greatly simplifies the Proposed Regulations without changing the substantive results thereof.

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[6] This conclusion assumes that the transition relief provided under Proposed Regulation §1.162-27(h)(3) applies to compensation attributable to awards granted during the reliance period, regardless of when such compensation is paid.