REPORT #771

TAX SECTION

New York State Bar Association

Recommended Guidance Relating to $1 Million Limitation
on Deductible Compensation Under Section 162(m)
September 27, 1993

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M E M O R A N D U M

September 27, 1993

TO: Harry L. Gutman
Margaret Richardson
Leslie B. Samuels

FROM: Peter C. Canellos

RE: New York State Bar Association Tax Section Report on Section 162(m) of the Code

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Enclosed is a report of the Tax Section dealing with key interpretive questions under new Internal Revenue Code Section 162(m), the so called “$1 million cap” on deductible compensation.

The report raises a number of issues which need to be addressed promptly in order to permit corporations to comply with the new provision what it becomes effective on January 1, 1994. Compliance may involve taking certain action in connection with 1994 proxy materials, which will soon be prepared. Accordingly, the need for immediate guidance is of the highest priority.

The report suggests a number of resolutions to these issues which are designed to make the provision more administrable without undermining its legislative purpose. As the report notes some of these answers may not be fully consistent with the legislative history and some may require technical correction legislation.

As you know, the Tax Section was of the view that enactment of the new provision was unwise since it extended the tax law into areas better governed by federal securities law and state corporate law. With enactment of -the new provision, it becomes important to coordinate its implementation with the Securities and Exchange Commission, which has recently reviewed disclosure requirements relating to executive compensation. We would be happy to work with your staffs to facilitate such coordination.

Please call me with any question.

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Tax Report #771

NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMITTEE ON NONQUALIFIED EMPLOYEE BENEFITS
AND COMMITTEE ON QUALIFIED PLANS

Recommended Guidance Relating to $1 Million Limitation on Deductible Compensation Under Section 162(m)[1]

September 27, 1993

The provisions and legislative history of Section 162(m)[2] leave unanswered many key questions as to the proper interpretation and application of that section in commonly occurring situations. Immediate guidance on these issues is urgently needed, particularly in view of the procedural requirements the statute imposes under the performance-based compensation exception, which requires advance approval by a compensation committee consisting of outside directors as well as a shareholder vote.

The purpose of this Report is to identify a number of issues which are in need of immediate clarification, and to set

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”). Helpful comments were also received from Peter C. Canellos, Stephen L. Gordon, 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) (the “Act”), unless otherwise indicated.

forth the Committee's recommendation as to how the statute should be interpreted and applied in such situations. The recommendations reflect the Committee's view that, to the extent consistent with simplicity of administration, Section 162(m) should be interpreted in a manner consistent with the reporting requirements historically imposed by the Securities and Exchange Commission (“SEC”).

In light of the fact that options and other equity awards are being granted daily without clear guidance on the effect of Section 162(m) and in view of the short lead time before the 1994 proxy season, at which time any necessary shareholder action would have to be taken, the Committee urges that the Treasury Department and the Internal Revenue Service (the “Service”) issue guidance on these interpretive questions under Section 162(m) well in advance of the January l, 1994 effective date of the statute for calendar- year taxpayers. To that end, the Committee suggests that such guidance take the form of a series of questions and answers, and the recommendations that follow use such a format. The Committee notes that the suggested interpretations of Section 162(m) contained herein are not uniformly in accord with the Conference Report[3] which accompanied Section 162(m), and in some cases might require a technical correction to Section 162(m). In those instances in which our recommendations differ from the legislative history, our goal has been to provide a workable and practical framework within which the corporations subject to Section 162(m) may compensate their top executives.

[3] H.R. Rep. No. 213, 103d Cong., 1st Sess. (1993).

Affiliates

Q-l: Can compensation paid by an affiliate of a publicly held corporation be subject to the limitations of Section 162(m)?

A-l: Yes. Section 162(m) applies to compensation otherwise deductible by a publicly held corporation (as defined in Section 162(m)(2)) and those corporations which are members of the "affiliated group," as defined in Section 1504, which includes the publicly held corporation. A single $1 million cap applies to the entire group for each covered employee, and is apportioned to each member in proportion to the applicable employee remuneration of the covered employee deductible (without regard to Section 162(m)) by each such respective member.

Rationale: On its face, the statute is limited in its applicability to a publicly held corporation and does not affect deductions otherwise available to subsidiaries of such corporation. Accordingly, if the publicly held corporation is a holding company and its covered employees perform substantially all their services for its operating subsidiaries, or if an individual whose compensation is described in the publicly traded corporation's proxy statement is actually an officer of a subsidiary and is not an employee of the publicly held corporation, no deduction or virtually no deduction will exist at the level of the publicly traded corporation and Section 162(m) will have little or no effect.

While the Committee believes that a technical correction is necessary to implement its recommendation, in order to avoid totally arbitrary application of Section 162(m) it is the Committee's view that Section 162(m) should be applied to compensation for services performed for the publicly held corporation and its 80-percent controlled subsidiaries. This follows the rules of Section 1504 relating to affiliated groups of corporations for consolidated return purposes, and is similar to the rule applicable under the golden parachute provisions. See Section 280G(d)(5).

On the other hand, the Committee does not think it appropriate to limit deductions of corporations which, under the foregoing principles, would not be part of the same affiliated group as the publicly held corporation. This would include, for example, 50-percent owned joint venture corporations.[4]

Covered Employees

Q-2: Who are "covered employees" for purposes of Section 162(m)?

A-2: Covered employees are:

(i) the employee who is the chief executive officer of the publicly traded corporation as of the close of the taxable year; and

(ii) the four individuals (other than the chief executive officer) for whom, under the proxy disclosure rules of the Securities and Exchange Commission as in effect on the date of enactment of the Act, total compensation for the taxable year is required to be reported to shareholders.

Rationale: There are two reasons why this Question and Answer has been included, although in essence the Question and Answer merely repeats and slightly amplifies the statutory language.[5]

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4 While not requiring immediate guidance, it must also be determined how compensation paid to a covered employee who receives compensation from a partnership, of which a member of the affiliated group is a partner, is to be treated under the $1 million cap.

5 Although no immediate guidance is required due to the relative infrequency of such occurrences, additional guidance will also be needed as to the identity of the covered employees where a publicly held corporation's fiscal year and taxable year do not coincide. Section 162(m)(3) operates on a taxable year basis, whereas the SEC proxy rules operate on a fiscal year basis. In cases where such periods do not coincide the problems of identifying the proper non-CEO officers to whom the statute applies and the application of Section 162(m) to their compensation may be considerable.

First, in recently proposed changes to the proxy disclosure rules the SEC has increased the number of individuals for whom disclosure is potentially required. This change, if adopted, would cause significant ambiguity regarding the identity of the four individuals whose compensation is affected by the terms of Section 162(m)(3)(B).

Under the newly proposed SEC rules, the compensation of all CEOs of the publicly held corporation during the year (as opposed to the CEO as of the close of the taxable year) would have to be disclosed and the compensation of up to two additional non-CEOs would have to be disclosed under certain circumstances. To conform Section 162(m) to these proposed rules would require a substantive statutory change. Absent such a change the clearest guidance which the Treasury and the Service can supply is to indicate that Section 162(m) is to be read coextensively with the SEC proxy rules in effect on the date of enactment of the Act.

The second reason for this Question and Answer is to reinforce the conclusions of Q&A-l. Under SEC proxy disclosure rules, an individual who is not an employee of the publicly held corporation (i.e., is an officer of a subsidiary) could be among the individuals whose compensation must be disclosed by the publicly held corporation. By its terms, Section 162(m)(3) only applies to an “employee of the taxpayer.” Read in context, the taxpayer means the publicly held corporation. Accordingly, as in the situation described in Q&A-l, a technical correction will be required to deny a subsidiary a deduction for compensation payable to one of its employees whose compensation must be reported by the publicly traded parent corporation but who is not an employee of the parent corporation.

Compensation Committee

The following questions and answers attempt to provide much-needed guidance with respect to the composition of a compensation committee, including specifically the definition of “outside director” set forth in the Conference Report.

Q-3: In order to be an “outside director” for purposes of Section 162(m)(4)(C), a director may not be a current employee of the publicly held corporation or a “related entity.” What is a “related entity” for this purpose?

A-3: A “related entity” is (i) an entity in which the publicly held corporation holds, directly or by attribution, 50 percent or more of the value or voting power of the ownership interests; or (ii) an entity which holds, directly or by attribution, 50 percent or more of the value or voting power of the stock of the publicly held corporation. For this purpose the attribution rules of Section 318 shall apply.

Rationale: In providing guidance it would be most helpful to establish a “bright line” standard for what constitutes a related entity. The Committee believes that a related entity probably should include any entity which controls or is controlled by the publicly held corporation; for this purpose a 50 percent ownership threshold would seem a reasonable place to draw the line.

Q-4: Can a former officer of the publicly held corporation or a related entity ever be an “outside director”?

A-4: First it is necessary to identify those individuals who are former officers of a related entity. For this purpose an individual is a former officer of a related entity only if he or she was an officer, within the meaning of Section 416, of an entity during any period of time in which that entity was a related entity. (See Reg. § 1.416-1, T-13.) Moreover, if a former officer of the publicly held corporation or a related entity has not received compensation from the publicly held corporation or related entity for personal services performed during the past five years other than as an outside director, the individual's former officer status will not preclude him or her from being an outside director.

Rationale: Any provisions which preclude a former officer from being an outside director should, in the Committee's view, probably be narrowly construed and should be administered in a manner which prevents undue administrative burden on the taxpayer. The Committee believes the foregoing provisions, which include the cessation of a “former officer” status for those whose officer duties ended at least five years previously, would be helpful in accomplishing this result, although we recognize that the Conference Report seems to preclude a person who was an officer of the publicly held corporation or a related entity “at any time” from being an outside director.

Q-5: When is an individual currently receiving compensation for services in a capacity other than as director and therefore ineligible to be an outside director?

A-5: An individual is ineligible to be an outside director by reason of currently receiving compensation for services in any capacity other than an outside director if the individual, or any entity of which the individual is a “key employee” within the meaning of Section 416(i)(1) or a 5-percent owner (see Section 416(i)(1)(B)(i)) (determined without regard to the 4-year lookback rule of Section 416(i)(l)(A)), is receiving “material” compensation from the publicly held corporation or a related entity for acting in any capacity other than as an outside director. Compensation is material for this purpose if it comprises 5 percent or more of the gross income of such person for his or her most recent taxable year or of the gross revenue of such entity for its most recent fiscal year.

Rationale: This Question and Answer attempts to resolve two issues. The first issue is whether an individual can be an outside director if such individual is a director who also receives direct compensation from the publicly held corporation or a related entity for services rendered in a non-director capacity. While the Conference Report provides a fairly clear negative answer to that question, it is the sense of the Committee that receipt by a director of compensation which is immaterial should be disregarded. While reasonable people could differ on the threshold of materiality, the Committee chose 5%, largely based on Item 404(b)(4) of Regulation S-K promulgated by the SEC, which requires disclosure of certain director compensation.

The second issue concerns the circumstances under which a director who is an equity participant in an entity which receives compensation for performing services for the publicly held corporation or a related entity may qualify as an outside director. A common fact pattern which raises this issue is that of an individual who is both a member of the board and a lawyer, accountant, or investment banker whose firm renders services to the publicly held corporation. The question is, at what point does such an individual become ineligible to be an outside director? This fact pattern, with respect to which the Conference Report is silent, has already caused substantial and recurring problems in determining who can qualify as an outside director. In the Committee's view, payment of immaterial compensation to an entity, or any payment to an entity in which the individual has an immaterial interest, should not disqualify that director from being an outside director.

Q-6: How does the requirement for approval by outside directors apply in the case of a privately held company which subsequently becomes publicly held?

A-6: In view of the remote likelihood that option grants or other performance-based compensation payable to officers of privately held companies would have been approved initially by outside directors, the outside- director requirement for privately held companies which subsequently become public is waived for those options granted or other performance-based compensation commitments made during periods in which the company was private.

Rationale: The requirement that option grants and other forms of performance-based compensation be approved by outside directors should be waived for private companies because (i) such companies are not subject to Section 162(m), and it is unreasonable to require them to operate as if these rules will become applicable to them at some future date, and (ii) directors of privately held companies are not typically “outside directors,” and therefore insistence that the outside-director requirement of Section 162(m) be met would simply negate the relief otherwise afforded from shareholder approval' requirements to privately held companies which subsequently become public.

Q-7: Is it permissible for a subcommittee of a compensation committee to serve as the compensation committee for purposes of Section 162(m) if such subcommittee consists solely of outside directors?

A-7: Yes.

Rationale: There is no legitimate policy reason to force a company to change the composition of its compensation committee solely for tax purposes where there are already a sufficient number of outside directors on the compensation committee to form a subcommittee satisfying the requirements of Section 162(m).

Performance-Based Compensation

Q-8: What provisions must be contained in a stock option plan to satisfy the requirement that the plan specify the class of executives to which it applies?

Q-8: The requirement that an option plan specify the class of executives to which it applies will be considered satisfied by a general designation of the class of employees eligible to receive options under the plan. Such designations as “key employees of the grantor corporation,” “all salaried employees of the grantor corporation and its subsidiaries, including subsidiaries which become such after adoption of the plan” or “all employees of the corporation” will meet this requirement.

Rationale: The foregoing Answer is borrowed directly from Prop. Reg. § 1.422A-2(b)(3)(iii) which deals with a similar requirement - namely that an incentive stock option (“ISO”) plan must designate the employees or class of employees eligible to receive options under the plan. See Prop. Reg. § 1.422A-2(b)(3)(i). Since executives are a subcategory of all employees, a plan which makes options available to all employees clearly encompasses all executives. To require plans which currently permit option grants to all employees to be amended to mention executives specifically and subsequently to be reapproved by shareholders would result in corporate activity and expense for no particular purpose. We have recommended the ISO-type approach set forth above to avoid the imposition of needless and meaningless additional requirements under Section 162(m).

Q-9: What provisions must be contained in a stock option plan to satisfy the requirement that “the maximum number of options that an individual executive may receive during a specified period is predetermined”?

A-9: Consistent with the existing mandate of Rule 16b-3 promulgated under the Securities Exchange Act of 1934, as well as the approach recommended under Q&A-8 above, it is sufficient for a stock option plan (including an omnibus plan under which stock options and other stock-based awards may be granted) to specify a maximum number of shares reserved for issuance under the plan during its term.

Rationale: For the reasons set forth below, the Committee believes that requiring greater specificity will unduly restrict the outside directors' ability to tailor option grants to executives and other employees; will lead to a number of interpretive issues under Section 162(m); and will not serve to foster any tax or other policy objective.

The Conference Report states that “[i]t is intended that the directors may retain discretion as to the exact number of options that are granted to an executive, provided that the maximum number of options that the individual executive may receive during a specified period is predetermined.” It is unclear whether this language should be interpreted to require that separate “individual maximums” be set forth in the option plan for each executive or whether it is sufficient for the plan to set forth the total number of shares reserved for issuance under the plan during its term (the latter approach effectively establishes a ceiling on the number of options that could be granted to any individual). The Committee prefers the latter approach because it is more in accord with present corporate compensation practices, in the Committee's view is not inconsistent with the language of the Conference Report, and can be implemented in a manner consistent with the purposes of Section 162(m).

In support of its position, the Committee notes that the Rule 16b-3 standard regarding the maximum number of shares available for stock option grants is well-known and long-standing, and the vast majority of options plans of which we are aware do not impose maximums on individual grants. Further, the SEC requires that companies specifically disclose in their annual proxy statements (1) the specific option grants made to each covered employee during the previous fiscal year (including the number of options granted, the percentage of such options to the total number of options granted to all employees in that year, the exercise price, and either the grant date value or the potential realizable value of such options)[6] and (2) information regarding each exercise of options by each covered employee during the past fiscal year (including the value realized) and the number and value of unexercised options at fiscal year end.[7] Such disclosure provides meaningful information to shareholders and, in the Committee's view, provides further support for not requiring existing plans to be revised to contain (or to be resubmitted to shareholders solely to approve) “individual maximums.”

The Committee also believes that application of an “individual maximum” requirement could be difficult, especially in view of the fact that the identity of the covered employees

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[6] See Item 402(c) of Regulation S-K.

[7] See Item 402(d) of Regulation S-K.

may change each year. For example, consider the grant of a nonqualified stock option to an individual who is not a covered employee at the time of grant but who is a covered employee at the time of exercise. Any "individual maximums" contained in the plan which were applicable to covered employees would not have been applicable to such individual at the time of grant. It would be anomalous for the income recognized by such individual (or by another covered employee) upon exercise to fail to constitute "performance-based compensation" merely because the plan failed to contain an "individual maximum" for such individual.[8]

Unless the Treasury and the Service truly intend to regulate the permissible size of individual maximum grants, the Committee believes that any limit imposed on individual grants, including the same limit as that imposed on maximum grants under the plan, should be permissible for purposes of Section 162(m). Therefore, those option plans which currently impose an aggregate maximum on shares for which options may be granted should be deemed to satisfy the requirement that the plan specify the maximum number of options that an individual executive may receive. A contrary result will require nearly all existing stock option plans to be revised and perhaps resubmitted to shareholders to approve these individual maximums without any significant policy justification.

In sum, as long as shareholders approve the authorization of a maximum number of shares to be available for option and similar grants, the Committee sees no valid purpose in

[8] Similarly, in the case of an optionee who is a covered employee at the time of grant but who is no longer a covered employee at the time of exercise, the existence (or non-existence) of an "individual maximum" for such individual is entirely irrelevant to the characterization of such individual's (or any other covered employee's) income as "performance-based" because the individual is no longer a covered employee.

causing companies to depart from traditional practice by requiring greater specificity as a condition of ensuring tax deductibility of compensation income arising upon exercise of such options.

Q-10: When is compensation paid to an executive pursuant to a preestablished objective performance formula or standard that precludes discretion?

A-10: As long as the performance goals themselves are objective [9] and a third party with knowledge of the relevant performance results can calculate the maximum amount that can be paid to a covered employee, the amount actually paid qualifies as performance-based compensation.

Rationale: The Conference Report provides that [compensation (other than stock options or other stock appreciation rights) is not treated as paid solely on account of the attainment of one or more performance goals unless the compensation is paid to the particular executive pursuant to a preestablished objective performance formula or standard that precludes discretion. In general, this means that a third party with knowledge of the relevant performance results could calculate the amount to be paid to the executive."

The Committee recognizes that, read literally, the above-quoted language could be interpreted to prohibit the outside directors from exercising any discretion in determining, for example, the annual bonus of a covered employee. However, the Committee believes a somewhat more liberal interpretation can be adopted without undermining in any way the basic objective of

[9] The Committee believes that otherwise objective performance goals should not be disqualified solely by virtue of discretionary adjustments (authorized by the plan) which may be made by outside directors to reflect such things as acquisitions, dispositions, corporate restructurings, recapitalizations, or other unusual or non-recurring events, changes in accounting rules and the like.

Section 162(m).[10]

Virtually all bonus programs (other than equity- based programs driven solely by stock price) of which we are aware reserve to the compensation committee the discretion to base some portion of the bonus on their evaluation of the individual performance of the executive. The proposed Answer above attempts to strike a balance between (i) the obvious intent of the Conference Report to make bonuses objectively determinable in order to be deductible and (ii) the capacity (if not obligation) of a corporation's outside directors who comprise the compensation committee to factor into the amount of bonus payable to a covered employee their analysis of individual performance of the executive during the period covered by the bonus plan, without sacrificing the corporation's tax deduction. The proposed solution requires shareholder approval of the objective performance goals and the maximum bonus which can be awarded to the covered employee but reserves to the compensation committee of outside directors the ability to exercise its legitimate function of evaluating individual performances within the shareholder-approved parameters (e.g., by awarding less than the maximum).

The application of our suggestions can be illustrated by the following example: Company X maintains an annual bonus plan which has been approved by shareholders. The plan provides for the creation of an aggregate bonus pool equal to y percent of all

[10] For example, the Committee notes that, in discussing the standards applicable to stock options, the Conference Report provides that it is sufficient if the maximum number of options is predetermined. Further, in discussing shareholder approval and adequate disclosure, the Conference Report provides that “[i]t is expected that shareholders . . . will be made aware of the general performance goals on which the executive's compensation is based and the maximum amount that could be paid to the executive if such performance goals were met” (emphasis added).

pre-tax earnings for the year above a specified level. The plan further provides that z percent of the overall bonus pool is to be allocated among executive officers (which includes all covered employees).

Under these circumstances, a third party with knowledge of the performance results will know the precise amount of the aggregate bonus pool available to executive officers and thus will know the maximum bonus payable to any covered employee. The mere fact that outside directors retain the discretion to allocate the available pool among executive officers does not, in the Committee's view, represent the type or degree of discretion that should preclude treatment of the bonus as performance-based.

Should the Service conclude, however, that the exercise of such discretion is impermissible, the Committee wishes to propose the following as an alternative: under these circumstances, it would be permissible for the plan to provide a range of potential amounts (expressed as a minimum, target and maximum amount or percentage of the available pool) to which each executive officer (or each covered employee) is entitled. Thus, the discretion of the outside directors would be limited to determining, within the specified ranges, each executive officer's (or each covered employee's) precise portion of the available pool.

The Committee notes that this alternative is based on the present SEC disclosure rules governing long-term incentive plan awards, the value of which is not based on stock price. See Item 402(e) of Regulation S-K. In the table required by Item 402(e), the Company must set forth for each covered employee, among other things, the estimated payout or range of estimated payouts under the award (such estimate to be expressed as a threshold, target, and maximum amount).

The Committee believes that use of either of the foregoing approaches would be consistent with the overall objectives of Section 162(m), while not unduly interfering with the discretion traditionally exercised by outside directors to analyze the individual performance of covered employees in determining their bonus levels.

Q-11: When will compensation be treated as paid solely on account of the attainment of one or more performance goals?

A-11: Compensation will be considered to be paid solely on account of the attainment of one or more performance goals if either (i) the compensation is paid only if a specified level of performance is attained or (ii) the amount of compensation paid depends on the level of the relevant performance measure. Thus, for example, cash compensation may qualify as performance-based compensation if it is payable by reason of the attainment of a target level of return on investment, if it is calculated as a fixed percentage of the revenues of a corporate division or if it is based upon relative performance by comparison with an industry-wide or self-constructed index of peer-group companies.

Rationale: The Conference Report states that performance goals are intended to be broadly defined and are intended to include any objective performance standard that is applied to the individual covered employee, a division or line of business, or the corporation as a whole, including “for example, increases in stock price, market share, sales, or earnings per share.”

Successful performance cannot be judged in the abstract. A chief executive hired to downsize a large corporation, for example, might be judged to have done a superb job even if conventional measurements of the corporation's performance for several years show contraction and losses. The Committee believes that the dual requirement in the Act that performance goals be established by a compensation committee of outside directors and be approved by shareholders properly delegates to the directors and owners of a corporation the responsibility for tailoring performance goals to the particular facts and circumstances of that corporation. For that reason, although the examples of objective performance goals in the Conference Report all involve an "increase" in the relevant measure of performance, the Committee believes that the Conference Report does not provide, and should not be read to provide, that the only performance goals that will be recognized under Section 162(m) require a period-to-period increase in the measured level of performance.[11]

Shareholder Approval

Q-12: Where amendments to an existing plan are necessary to comply with the requirements of Section 162(m), will companies have to get new shareholder approval of such amendments?

A-12: New shareholder approval will not be required where (i) the plan was previously approved by shareholders, (ii) in the case of a performance plan other than a stock option plan the plan had contained a predetermined formula for determining the maximum amount payable to any covered employee, and (iii) the amendment could have been made without shareholder approval under the plan as previously in effect.

Rationale: In the event the Treasury does not agree with the Committee's recommendation set forth in Q&A-9 and requires greater specificity with regard to the maximum number of shares available for option grants to specific employees, the Committee believes it would be unduly burdensome for companies to have to seek new shareholder approval of an amendment adopted to reflect

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[11] A contrary result would be difficult to square with the statute's treatment of commission income as performance based. Since an annual commission could be paid year after year for the same performance and still be deductible, it would be logically inconsistent to require period-to-period performance increases in order for non-commission income to qualify as performance based.

Obviously, if a performance standard is not bona fide but is a mere subterfuge for the payment of direct compensation, the compensation should not qualify as performance based.

that requirement. Similarly, in the case of other performance-based plans which contain an existing formula but, for example, do not adequately limit the compensation committee's discretion for determining individual awards, it would not further the objectives of the statute to require the company to obtain new shareholder approval for the adoption of what is effectively a restrictive amendment.[12]

Grandfathered Payments

The following questions and answers attempt to provide guidance with respect to the Section 162(m)(4)(D) grandfather rule, which exempts from the scope of applicable employee remuneration compensation paid under a written binding contract which was in effect on February 17, 1993.

Q-13: When is an amount payable "under" a written binding contract?

A-13: Remuneration is payable under a written binding contract if payment of the remuneration is mandated by the terms of such contract. If the employer has the discretion to determine the amount of any compensation under the contract, such compensation will be grandfathered only to the extent it does not exceed the amount that would have been payable assuming that the employer had exercised such discretion after February 17, 1993 in such a manner as to minimize the amount of compensation paid under the contract.

Thus, for example, if an employment agreement that was in effect on February 17, 1993 provides for a minimum salary which may be (but is not required to be) increased from time to time, salary would not be grandfathered to the extent that it exceeded the salary mandated as of February 17, 1993. Similarly, if the contract provides for a minimum bonus amount but reserves discretion to the employer to pay an additional bonus, only the minimum bonus would be grandfathered.

Rationale: The Committee does not believe that discretionary amounts that are permitted, but not required, to be

12 Similar transitional relief was afforded by temporary regulations related to incentive stock options. See Temp. Reg. § 14a.422A-l, Q&A-31, which waived the shareholder-approval requirement for amendments to option plans which added certain statutory limitations.

paid under the terms of a written binding contract fall within the intended meaning of payments “under” a written binding contract. A contrary result could effectively grandfather, with no limitation, all compensation paid to a covered employee during the term of an employment contract. On the other hand, payment of such discretionary amounts should not “ungrandfather” the remainder of the compensation paid under the contract.

Q-14: Under what circumstances is a written binding contract considered to have been modified in a material respect?

A-14: A written binding contract is considered to have been modified in a material respect if provisions for or affecting compensation that (but for the application of Section 162(m)(4)(D)) would constitute applicable employee remuneration are added to the contract, or are amended or supplemented, so as to provide significant additional benefits to the covered employee.

Rationale: Amendments to a written binding contract that do not significantly increase a covered employee's compensation that is potentially subject to Section 162(m), or materially alter the circumstances under which such compensation is paid, are not logically relevant to such section and should not affect the eligibility for grandfather treatment. For proposed regulations that adopt this principle in an analogous context, see Prop. Reg. § 1.280G-1, Q&A-50.

Q-15: If the amount of remuneration payable pursuant to a written binding contract is increased as a result of a material modification to the contract, is any portion of such remuneration grandfathered?

A-15: Yes. The portion of the remuneration that would have been required to be paid to the covered employee without regard to the material modification is treated as remuneration payable under a written binding contract which was in effect on February 17, 1993, and is grandfathered.

Rationale: A material modification to a contract to increase compensation is in many respects similar to an employer's payment of discretionary amounts that are not mandated under the terms of the written binding contract. The above treatment would cause the two situations to be treated in the same manner for purposes of the grandfather rule.

A contrary rule could in many cases be circumvented by paying the additional compensation to the covered employee independently of the written binding contract, rather than as a result of a material modification of the contract.[13]

Q-16: Under what circumstances does compensation paid pursuant to a plan qualify for the grandfather rule?

A-16: (a) Compensation paid pursuant to a plan is grandfathered provided that the right to participate in the plan is part of a written binding contract with the covered employee in effect on February 17, 1993 (whether or not the covered employee was a plan participant on that date) and provided that the plan meets the other conditions of the written binding contract exception (e.g., the plan is in writing, has been in existence since February 17, 1993, and has not been materially amended since that date).

(b) If the employer has the discretion to determine the amount payable to the covered employee under the plan, or to terminate or modify the plan without the covered employee's consent, the grandfathered portion of the compensation paid under the plan will be determined by applying the principles of Q&A-13 (that is, grandfather treatment will be limited to the minimum amount that would have been payable assuming that the employer had exercised such discretion after February 17, 1993 in such a manner as to minimize the amount of compensation payable to the covered employee under the plan).

For example, suppose that a written binding employment contract between corporation C and covered employee A provides for A's participation in plan P, a non- discretionary long-term incentive bonus plan under which a bonus is determined pursuant to an objective formula based on corporate performance over a measurement cycle consisting of the five calendar years preceding the year in which the bonus is paid. Assume that Plan P provides that without an employee's consent the plan cannot be terminated or modified (in a manner that would result in a material adverse effect on the employee) with respect to any bonus payable on account of a five-year cycle that has already commenced as of the time of such termination or modification. Assume that the plan otherwise satisfies the requirements for the written binding contract exception.

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[13] The Committee recognizes that the above proposal appears to be inconsistent with the language of the statute and the grandfather-rule description in the Conference Report, which imply that grandfather relief would be lost entirely if the written binding contract were modified in any material respect before the remuneration was paid. Accordingly, a technical correction to the statute may be necessary to implement the Committee's proposal.

In this example, had corporation C exercised its discretion after February 17, 1993 in the manner that would have minimized the payments under the plan, it would have terminated Plan P effective beginning with the 1994-98 cycle. Accordingly, benefits paid under the plan on account of that and subsequent cycles would not be grandfathered. Since Corporation C could not exercise its discretion after February 17, 1993 in a way that would terminate the plan with respect to benefits paid on account of earlier cycles, however, bonuses payable with respect to cycles ending before 1998 will be grandfathered.

Rationale: The above principles are consistent with the intent reflected in the Conference Report that compensation paid under a plan be grandfathered if the requirements for the grandfather rule are otherwise satisfied. The Conference Report can be read to imply, however, that if an employer has the unilateral right to terminate or modify a plan, but only on a prospective basis, the existence of such right does not affect the amount of the grandfathered payment under the plan. The Committee believes it would be more consistent with the principle that only payments mandated under a written binding contract should be grandfathered to limit grandfathering to those amounts that would have been paid if the employer had exercised such discretion after February 17, 1993 in the manner that would minimize the payment to the covered employee.

Q-17: In order for remuneration pursuant to a written plan to be grandfathered, must a separate written binding contract provide for the covered employee's participation in the plan?

A-17: In general, yes. If, however, the payment is made pursuant to a written plan under which the obligation of the employer is essentially the same as under a written binding contract, and the requirements of 162(m)(4) are otherwise satisfied, the payment will be grandfathered.

Rationale: It is consistent with the apparent purpose of the grandfather rule to treat as a written binding contract any written plan under which a participant has enforceable rights tantamount to the rights conferred under a written binding contract. Indeed, it may be argued that such a plan itself constitutes a written binding contract.[14] The Treasury Department has adopted this view in the context of at least one other grandfather rule.[15]

Q-18: If a written binding contract provides for a covered employee's participation in a plan, and the rules regarding the grandfathered status of payments from a plan are otherwise satisfied, will any portion of a benefit paid under the plan be grandfathered if such payment includes benefits attributable to periods after the expiration of the written binding contract?

A-18: Yes. In this circumstance, the plan benefit will be grandfathered to the extent it does not exceed the amount that would have been paid had the participant's participation in the plan terminated at the end of the term of the contract.

Rationale: Since the contract mandated the payment of at least the amount that would have been paid had the participant's participation in the plan terminated at the end of the contract term, logically that amount should be viewed as paid pursuant to the contract whether or not the covered employee becomes entitled to additional benefits under the plan attributable to subsequent periods of employment.

Q-19: If the terms of a written binding contract permit an employee to make a unilateral election that will affect the timing or amount of remuneration payable under the contract, will the fact that after February 17, 1993 the employee makes such an election affect the grandfathered status of remuneration paid under the contract?

A-19: No. If under the terms of the contract the employee may make an election (for example, an election of the form or timing of his or her benefit under a deferred compensation plan, or an election of a phantom investment fund for determining the earnings credited to deferred compensation) without the consent of the employer, the covered employee's exercise of such right will not constitute a material modification of the

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[14] See Carr v. First Nationwide Bank, 816 F. Supp. 1476 (N. D. Cal. 1993) and the cases cited therein.

[15] A regulation creating a grandfather rule on the tax treatment of nonqualified annuities extends grandfather treatment not only to payments made pursuant to a binding written contract entered into before the grandfather date but also payments “pursuant to a written plan . . . under which the obligation of the employer is essentially the same as under a binding written contract.” Reg. § 1.403(c)-l(d)(1)(iii).

written binding contract or otherwise affect the grandfathered status of the related remuneration.

Rationale: Because the covered employee's election of an option available under the terms of a written binding contract as of February 17, 1993 does not cause the employee to receive compensation in excess of the amount to which the employee contractually was entitled, the grandfather rule should apply. An amendment of the contract to add an option not available as of February 17, 1993 should be analyzed for purposes of the grandfather rules in the same manner as any other contract amendment.

Additional Transition Relief

The committee recommends that additional transition relief be granted in the situations set forth below. The rationale for the proposals is that transition relief is needed to reflect the fact that after February 17, 1993 but before enactment of Section 162(m)(4)(C) or before clarification of its procedural requirements, many employers will have entered into employment contracts with covered employees or made grants of stock options or similar awards to such employees.

Q-20: Is transition relief available with respect to the shareholder disclosure and approval requirements of Section 162(m)(4)(C)(ii)?

A-20: Yes. If compensation paid under a written binding contract entered into before the date of enactment of the Act would (but for the requirements of 162(m)(4)(C)(ii), and after taking into account the transition rule of Q&A-21) constitute performance-based compensation meeting the requirements of Section 162(m)(4)(C), the requirements of Section 162(m)(4)(C)(ii) will be deemed to have been satisfied. This transition relief does not apply to stock options or stock appreciation rights (SARs) (but see QSA-9 and Q&A-22).

Rationale: Prior to passage of the Act, it would have been impossible for an employer to determine with any certainty what procedural requirements would apply in order for remuneration that otherwise qualifies as performance- base compensation to be exempted from the scope of Section 162(m). Because, in the Committee's view, a retroactive shareholder ratification of a previously executed contract would not be meaningful, and in view of the inequities that would result without such relief, the shareholder disclosure and approval requirement should be deemed to have been satisfied in this circumstance.

Q-21: Is transition relief available with respect to the requirements of Section 162(m)(4)(C)(i) (relating to the approval of performance goals by a compensation committee consisting of two or more outside directors)?

A-21: Yes. If compensation paid pursuant to a written binding contract entered into prior to the date 30 days after the issuance of question and answer guidance on Section 162(m) would (after giving effect to the transition rule in Q&A-20), constitute performance-based compensation meeting the requirements of Section 162(m)(4)(C) but for the fact that the performance goals were determined by a compensation committee of the board of directors (or by the entire board of directors) not all of whose members were “outside directors,” the requirements of Section 162(m)(4)(C)(i) will be deemed to have been satisfied.

Rationale: In view of the substantial uncertainty surrounding the definition of an “outside director,” transition relief is needed for the period prior to the time employers have had an opportunity to restructure their compensation committee so as to limit the committee to “outside directors.”

Q-22: Is transition relief available with respect to stock options and stock appreciation rights?:

A-22: Yes. In the case of options or SARs granted on or before the date 30 days after the issuance of question and answer guidance on Section 162(m), any compensation attributable to such options or SARs shall not be deemed to fail to satisfy the requirements of Section 162(m)(4)(C) merely because the shareholders did not approve the maximum number of shares subject to an option that could be awarded under the plan to any executive.[16]

In addition, to the extent otherwise applicable the transition relief provided under Q&A-21 shall be available with respect to stock options and SARs.

Rationale: In view of the substantial uncertainty surrounding the indication in the Conference Report that shareholders must approve the maximum number of shares subject to an option that can be awarded to any executive, transition relief is needed for the period prior to the issuance of guidance clarifying this requirement.

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16 This relief is needed only if the Service does not adopt the Committee's recommendation that the maximum- share requirement be deemed to have been satisfied in the case of any plan that states the maximum number of shares for which options can be granted (in the aggregate) under the plan. See Q&A-9.