



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE CHIEF COUNSEL ADVICE

MEMORANDUM FOR AREA COUNSEL (TE/GE) PACIFIC COAST/CENTRAL
MOUNTAIN AREA

Attention: Kirk Paxson

FROM: Acting Assistant Chief Counsel (Tax Exempt and
Government Entities)

SUBJECT: Application of Section 162(m) of the Internal Revenue Code

This Chief Counsel Advice responds to your memorandum dated March 28, 2001.
In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be
cited as precedent.

LEGEND

Corporation =
Executive =
Stock Incentive Plan =
Year A =
Year B =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =

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Date 6 =

Date 7 =

m =

n =

p =

ISSUE: Whether the compensation attributable to options issued, subject to shareholder approval, on Date 1 under the Stock Incentive Plan and exercised by the Executive in Year A and Year B meet the exception for “performance-based compensation” under section 162(m)(4)(C) of the Internal Revenue Code.

CONCLUSION: The compensation attributable to options issued, subject to shareholder approval, on Date 1 under the Stock Incentive Plan and exercised by the Executive in Year A and Year B meets the exception for “performance-based compensation” under section 162(m)(4)(C) of the Code.

FACTS: The facts as we understand them are as follows. Corporation established a Stock Incentive Plan under which it had granted options for Corporation stock to various officers, key employees, and independent contractors. The Stock Incentive Plan was established prior to the enactment of section 162(m) of the Code. As originally approved by Corporation’s Board of Directors and shareholders, the Stock Incentive Plan was limited to the issuance of options to acquire m shares of stock. The Stock Incentive Plan did not state the maximum number of shares with respect to which options could be granted to any employee.

On Date 1, following the enactment of section 162(m) but prior to its effective date, the Compensation Committee of Corporation’s Board of Directors granted Executive nonstatutory options to purchase n shares of common stock. Similar grants were made to the other executive officers. At the time of the option grant, there were insufficient options available under the Stock Incentive Plan. Therefore the option grant was subject to shareholder approval to amend the Stock Incentive Plan to increase the number of options that could be issued under the Stock Incentive Plan from m to p.

Prior to requesting shareholder approval to increase the number of options available to be issued under the Stock Incentive Plan, proposed regulations were issued under section 162(m).

On Date 2, Corporation provided its shareholders with a proxy statement containing information related to the proposed Stock Incentive Plan amendment. The material stated that Executive had been conditionally granted additional stock

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options but that the grant was subject to the approval by the shareholders of the proposed amendment to the Stock Incentive Plan to increase the number of options available to be granted under the Stock Incentive Plan.

On Date 3, Corporation's shareholders approved the amendment to the Stock Incentive Plan. The Stock Incentive Plan was not amended to state the maximum number of shares with respect to which options could be granted during a specified period to any person.

The exercise price of the options granted to Executive was equal to the fair market value of the stock on the date of grant. One half of the options vested on Date 4 and were exercised on Date 5 (both in Year A). The remaining options vested on Date 6 and were exercised on Date 7 (both in Year B). Executive was a "covered employee" under section 162(m)(3) for both Year A and Year B.

LAW AND ANALYSIS

Section 162(a)(1) of the Code provides that there will be allowed as a deduction all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered.

Section 162(m)(1) provides that in the case of any publicly held corporation, no deduction shall be allowed under this chapter for applicable employee remuneration with respect to any covered employee to the extent that the amount of such remuneration for the taxable year with respect to such employee exceeds \$1 million. Section 162(m) applies to amounts which would otherwise be deductible for taxable years beginning on or after January 1, 1994.¹

Section 162(m)(4)(C) provides that applicable employee remuneration does not include any remuneration payable solely on account of the attainment of one or more performance goals, but only if (i) the performance goals are determined by a compensation committee of the board of directors of the taxpayer which is comprised solely of 2 or more outside directors; (ii) the material terms under which the remuneration is to be paid, including the performance goals, are disclosed to the shareholders and approved by a majority of the vote in a separate shareholder vote before the payment of such remuneration; and (iii) before any payment of such remuneration, the compensation committee referred to in clause (i) certifies that the performance goals and any other material terms were in fact certified.

¹As provided in the legislative history, the section 162(m) limitation applies when the deduction would otherwise be taken, which would be the year of exercise in this case. See H.R. Conf. Rep. No. 213, 103rd Cong., 1st Sess. 585 (1993), *reprinted in* 1993 U.S.C.C.A.N. 1088, 1274.

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On December 20, 1993, proposed Income Tax Regulations under section 162 were issued (58 FR 66310). Section 1.162-27(e)(2)(i) of the proposed regulations provided that qualified performance-based compensation must be paid solely on account of the attainment of one or more preestablished objective performance goals. Section 1.162-27(e)(2)(i) further provided that a performance goal does not include the mere continued employment of the covered employee. Thus, a vesting provision based solely on continued employment would not constitute a performance goal.

Section 1.162-27(e)(2)(vi)(A) of the proposed regulations provided that compensation attributable to a stock option is deemed to satisfy the requirements of (e)(2) if the grant or award is made by the compensation committee; the plan under which the option is granted states the maximum number of shares with respect to which options may be granted during a specified period to any employee; and, under the terms of the option or right, the amount of compensation the employee could receive is based solely on an increase in the value of the stock after the date of the grant or award.²

The preamble to the notice of proposed rulemaking containing the proposed regulations under section 162(m) provides:

Some have questioned why it would be necessary for the regulations to require an individual employee limit on the number of shares for which options or stock appreciation rights may be granted, where shareholder approval of an aggregate limit is obtained for securities law purposes. The regulations follow the legislative history, which suggests that a per-employee limit be required under the terms of the plan. The IRS and Treasury believe that a limit on the maximum number of shares for which individual employees may receive options or other rights is appropriate because it is consistent with the broader requirement that a performance goal include an objective formula for determining the maximum amount of compensation that an individual employee could receive if the performance goal were satisfied. A third party attempting to make this determination with respect to a stock option plan would need to know both the exercise price and the number of options that could be granted. 58 FR 66310, 66311

The legislative history for the performance-based compensation exception to section 162(m) provides:

² Amendments were made to the proposed regulations on December 2, 1994. Final regulations were published on December 19, 1995 (T.D. 8650, 60 FR 65534). The changes made to the proposed regulations by the final regulations are not relevant to the issue considered in this memorandum.

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Stock options or other stock appreciation rights generally are treated as meeting the exception for performance-based compensation, provided that the requirements for outside director and shareholder approval are met (without the need for certification that the performance standards have been met), because the amount of compensation attributable to the options or other rights received by the executive would be based solely on an increase in the corporation's stock price. In the case of stock options, it 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. H.R. Conf. Rep. No. 213, 103rd Cong., 1st Sess. 586-7 (1993), *reprinted in* 1993 U.S.C.C.A.N. 1088, 1275-6.

In the case of a stock option plan, the shareholders generally must approve the specific terms of the plan, the class of executives to which it applies, the option price (or formula under which the price is determined), and the maximum number of shares subject to option that can be awarded under the plan to any executive. H.R. Conf. Rep. No. 213, 103rd Cong., 1st Sess. 587 (1993), *reprinted in* 1993 U.S.C.C.A.N. 1088, 1277.

It is clear that the system under which performance-based options could be granted envisioned by the regulations and the legislative history is one where (1) the compensation committee would determine how many options could be granted to each covered employee during a specified period under a plan; (2) the exercise price of the option would be equal to the fair market value of the stock as of the date of the grant; (3) the information would be disclosed to the shareholders; and (4) the shareholders would vote whether or not to approve the grants. The compensation committee would have the discretion to determine how many options it would actually grant within the limit specified in the approval vote. If it stayed within the limit approved by the shareholders, the grants under the specified limit would be performance-based. If the compensation committee granted options exceeding that specified limit, grants in excess of the limit would not be performance-based.

We note that the term "plan" in our view should not be read so literally that the use of employment agreements or other documents is precluded, or that a "plan" may not be supplemented with other agreements. The regulations contemplate that both performance-based and non-performance-based compensation may be paid from a single plan. See section 1.162-27(e)(2)(viii) of the final regulations, Example 11. Thus, when dealing with an omnibus plan, other agreements are often necessary to spell out the specifics of each grant.

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In this case, prior to seeking shareholder approval, the Compensation Committee granted options to Executive, conditioned upon shareholder approval. The exercise price of the options was equal to the fair market value of the stock as of the date of grant. Corporation then disclosed to its shareholders how many shares it had conditionally granted to Executive and informed them that those grants would be approved with their vote to increase the number of shares available in the Stock Incentive Plan. This procedure in effect specified the maximum number of options that could be granted during a specified period (Date 1) and the shareholders approved such grant. Thus, this system is effectively the same as that specified in the regulations except that the Compensation Committee does not have discretion to grant a lesser amount of options than that specified in the disclosure to the shareholders. Accordingly, the options issued on Date 1 and exercised in Year A and Year B were performance-based compensation. We note that if additional option grants were made to Executive or other covered employees, such option grants would not be considered to be performance-based unless the shareholders approved the grants. If you have any further questions, please call (202) 622-6030.

By: Acting Assistant Chief Counsel
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