Office of Chief Counsel
Internal Revenue Service

memorandum

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date: MAY 27 1999

to: Chief, Examination Division, Southwest District
Attn: William Kennedy, Case Manager

from: District Counsel, Southwest District, Phoenix

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ubject: [redacted]
Executive compensation

DISCLOSURE STATEMENT

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ISSUE

1. Whether taxpayer's "gross-up" for taxes on executive's restricted stock is deductible under any of the exceptions to I.R.C. § 162(m).

2. Whether taxpayer may deduct the value of unrestricted stock under any of the exceptions to I.R.C. § 162(m).

CONCLUSION

1. and 2. Such amounts are likely deductible under the binding contract exception.

FACTS

As part of the compensation for some of its executives, the taxpayer's executive compensation committee adopted a resolution on [redacted] to provide a proposed stock incentive program, dated [redacted], for certain executives of the company. The [redacted] proposal provided in relevant part that participants "will be encouraged to retain their vested shares. [redacted] participants will be strongly encouraged to retain ownership . . . . To facilitate this objective, the tax impact to [redacted] participants will be paid by the company."

The taxpayer also had in place a stock incentive plan, known alternatively as [redacted], [redacted] and [redacted], which provided executives with unrestricted stock under certain circumstances. (Because such stock was unrestricted, there was no need for any gross-up provisions).

In the case of employee [redacted], his employment agreement, executed [redacted], provided that he would receive "(b) Incentive awards, options and incentive plans participation in accordance with terms and provisions of such plans as shall be adopted from time to time." The agreement specifically referenced participation in the stock incentive plan "at a target percentage of not less than [redacted]% . . . ."

During [redacted] and [redacted], [redacted]'s base salary was less than $[redacted]. Although the value of restricted stock received by [redacted] caused total compensation to exceed $[redacted], you indicate that the taxpayer has correctly reported this part of the transaction. Your concern is with the company's payment of substantial sums to the I.R.S. and other taxing authorities in order to cover anticipated tax liabilities caused by the distribution of restricted stock, as well as its deduction for stock distributed under the [redacted]. The taxpayer has properly included such amounts as income on [redacted]'s Form W-2; you believe, however, that § 162 may prevent the taxpayer from being entitled to the deduction it claimed for such disputed amounts.

DISCUSSION

I.R.C. § 162(m) generally limits publicly held corporations from deducting more than $1 million in any year as compensation for any single employee. There are many exceptions, however, to this general rule, of which the existing binding contract exception is relevant here. See I.R.C. § 162(m)(4)(D); Reg. § 1.162-27(h)(1). Under these provisions, the calculation under I.R.C. § 162(m) does not include any remuneration payable under a written binding contract which was in effect on February 17, 1993, and which was not modified thereafter in any material respect. Whether or not a binding contract exists is a question

of State law. Reg. § 1.162-27(h)(1)(i).

Arizona law provides that where the incorporating instrument clearly evidences an intent that another writing be made part of the contract, then such second instrument will in fact be incorporated into the contract. See Industrial Commission v. Arizona Power Co., 295 P. 305, 37 Ariz. 425 (1931); United California Bank v. Prudential Insurance Co., 681 P.2d 390, 140 Ariz. 238 (Ariz. App. 1983). In the present situation, [redacted]'s employment agreement clearly indicates that he is to receive such benefits "as shall be adopted from time to time by the Executive Compensation Committee . . . ." Such provision appears to demonstrate an intent by the parties that the company would comply with the terms of any plans adopted by the taxpayer, as part of its agreement with [redacted]. We therefore believe that under Arizona law, [redacted] could judicially enforce the provisions of the [redacted] resolution if the taxpayer failed to comply, including the portion requiring gross-up for taxes, and that such provisions therefore fall within the exception to I.R.C. § 162(m) for existing binding contracts.

Similarly with the [redacted], the contract executed [redacted] provides for [redacted]'s participation. Indeed, the employment agreement in this regard goes even further, defining certain of the requirements which the [redacted] must meet. Although we are not aware of any specific amendments to the [redacted], this provision requiring specific terms in any [redacted] would be strong evidence in favor of the taxpayer that any subsequent amendments or agreements to the [redacted] consistent with the terms of [redacted]'s employment agreement were merely done in compliance with its pre-existing obligations to [redacted]. Thus, except to the extent that any such [redacted] agreement or amendment dated after February 17, 1993 provides for benefits in excess of the amounts defined in the employment agreement, we believe that such amounts are deductible by the taxpayer.

We note that the taxpayer has indicated that the [redacted] was approved by shareholders. If this is the case, then an additional exception to I.R.C. § 162(m) might apply, that being the exception described in I.R.C. § 162(m)(4)(C) for certain pre-approved performance-based compensation. We would require more information, however, prior to giving a definitive opinion as to this exception.

We also wish to note that in arriving at the above conclusion, we have considered whether adoption of the corporate resolution approximately two weeks after the date of [redacted]'s contract affects these issues. The binding contracts exception only applies when such contract "was not modified (after February 17, 1993) in any material respect before such remuneration is paid." I.R.C. § 162(m)(4)(D). The regulations discuss "material modifications" as negating this

exception. Reg. § 1.162-27(h)(1)(iii)(A). It is unnecessary to determine in the present situation whether the [redacted] resolution materially altered any provisions which would have applied to [redacted] prior to that date. This is because such modification occurred before the effective date of the provision, February 17, 1993. The obvious purpose of such provision was to prevent taxpayers from subsequently attempting to avoid the limitations of § 162(m), while at the same time not punishing those who had in good faith entered into agreements before that date. Thus, even if the [redacted] resolution represented a material modification of the employment agreement, this would not affect the taxpayer's ability to deduct the amounts at issue, since such modification occurred before February 17, 1993.

Please note, we consider the opinions expressed in this memorandum to be significant large case advice. We therefore request that you refrain from acting on this memorandum for ten (10) working days to allow the Assistant Chief Counsel (Field Service) an opportunity to comment. If you have any questions regarding the above, please contact me at (602) 207-8052.

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