200016024

Internal Revenue Service

Index No.: 162.36-08

Department of the Treasury

Washington, DC 20224

Contact Person:

Telephone Number:

In Reference to:

Date: CC:EBEO:4-PLR-115188-99

JAN 19 2000

Attn:

Company =

Executive =

A =

B =

C =

date a =

year b =

date c =

date d =

date e =

date f =

date g =

date h =

date i =

k shares =

l shares =

139

PLR-115188-99

m shares =

s% =

$*v* =

This is in reply to a request for a ruling concerning whether compensation attributable to the exercise of an option granted to one individual at the time of the formation of the business qualifies under section 162(m)(4) of the Internal Revenue Code as performance-based compensation.

Company, formerly A and, prior to that, B, is a holding company. In anticipation of a business combination with Company, the board of directors of A concluded that Executive's services as chairman were essential to the future success of the company and therefore sought to attract and retain Executive as chairman of the board of A.

In date *a*, Company, which at the time was named B, consummated mergers with A and C, whereby A and C became subsidiaries of Company. Contemporaneous with the mergers, Company changed its name from B to A. The name change to Company occurred in year *b*. The business combination involving A and Company was approved by A's board of directors in date *c*.

The board, at a meeting held shortly before the merger on date *d*, authorized and directed the officers of Company to prepare a stock option plan for submission to the shareholders for approval at Company's next annual meeting, with such changes to be approved by the compensation/benefits committee of the board of directors. It is stated in the ruling request that this committee, made up of 3 members, including the chairman of the board of A, satisfied the requirements of a "compensation committee" under section 1.162-27(c)(4) of the Income Tax Regulations. The overriding reason for the plan was to provide a grant of options to Executive.

Shortly thereafter, at a meeting of the compensation committee on date *e*, the committee approved and granted options to purchase *k* shares of A common stock. Specifically, the compensation committee granted Executive, the newly elected chairman of the board, an option to purchase *l* shares of common stock (*s*% of the total shares authorized under the plan). The option grant was specifically conditioned on the approval of the plan by shareholders. The option was granted with an exercise price of $*v*, which was the closing price of the stock on date *f*, the last business day

140

prior to the date of grant. The option was to vest in four equal installments, commencing on the first anniversary of the date of grant.

On date g, the board of directors met and, among other things, ratified the compensation committee's action with respect to the option grant to Executive. The board formally adopted the plan on date h, subject to shareholder approval.

The plan and the option grant were submitted to a shareholder vote at the date i annual stockholders' meeting. The proposal to adopt the plan was approved by a majority of the voting power represented by shares present or represented by proxy at the meeting.

The term of the plan is ten years. The maximum number of shares that may be issued during that period under the plan and under a separate option plan for outside directors is m shares. Shares of stock allocable to unexercised or canceled options do not count towards this limit and become available again for issuance under the plan. The plan allows the compensation committee to determine the persons to whom options will be granted and the number of shares of stock to be subject to each option. The plan is to be approved by the shareholders within 12 months of adoption by the board. It also provides that any increase in the maximum number of shares must also be approved by the shareholders within 12 months of the date such increase is adopted by the board. Any options granted prior to shareholder approval, or in excess of the maximum limit previously approved by the shareholders do not become exercisable prior to approval of the plan or approval of the increase in shares, respectively.

Section 162(a)(1) of the Code allows as a deduction all the 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) of the Code provides that in the case of any publicly held corporation, no deduction is allowed for applicable employee remuneration with respect to any covered employee to the extent that the amount of the remuneration for the taxable year exceeds $1,000,000.

Section 162(m)(3) of the Code defines a "covered employee" to mean any employee of the taxpayer if as of the close of the taxable year, such employee is the chief executive officer of the taxpayer or is an individual acting in such capacity, or the total compensation of such employee for the taxable year is required to be reported to shareholders under the Securities Exchange Act of 1934 by reason of such employee

being among the 4 highest compensated officers for the taxable year (other than the chief executive officer).

Section 162(m)(4) of the Code defines "applicable employee remuneration", with respect to any covered employee for any taxable year, generally as the aggregate amount allowable as a deduction for the taxable year (determined without regard to section 162(m)) for remuneration for services performed by the employee (whether or not during the taxable year). However, pursuant to section 162(m)(4), the term does not include 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 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 shareholders and approved by a majority of the vote before the payment of the 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 satisfied.

Section 1.162-27(c)(4) of the regulations provides that the "compensation committee" means the committee of directors of the publicly held corporation that has the authority to establish and administer performance goals and to certify that performance goals are attained. The committee is comprised solely of two or more outside directors. See section 1.162-27(e)(3) of the regulations.

According to section 1.162-27(e)(1) the deduction limitation generally does not apply to qualified performance-based compensation.

Section 1.162-27(e)(2) of the regulations provides, in part, that qualified performance-based compensation must be paid solely on account of the attainment of one or more preestablished, objective performance goals. A performance goal is considered preestablished if it is established in writing by the compensation committee not later than 90 days after the commencement of the period of service to which the performance goal relates, provided that the outcome is substantially uncertain at the time the compensation committee actually establishes the goal. A performance goal is objective if a third party having knowledge of the relevant facts could determine whether

the goal is met. Performance goals can be based on one or more business criteria that apply to the individual, a business unit, or the corporation as a whole. A preestablished performance goal must state, in terms of an objective formula or standard, the method for computing the amount of compensation payable to the employee if the goal is attained.

Compensation attributable to a stock option is deemed to satisfy the requirements of paragraph (e)(2) if the grant 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, 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. See section 1.162-27(e)(2)(vi)(A) of the regulations.

Section 1.162-27(e)(4) of the regulations provides, in part, that the material terms of the performance goal under which the compensation is to be paid must be disclosed to and subsequently approved by the shareholders of the publicly held corporation before the compensation is paid.

Disclosure as to the compensation payable under a performance goal must be specific enough so that shareholders can determine the maximum amount of compensation that could be paid to any employee during a specified period. 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. Thus, for example, if compensation attributable to the exercise of stock options is equal to the difference in the exercise price and the current value of the stock, disclosure would be required of the maximum number of shares for which grants may be made to any employee and the exercise price of those options (*e.g.*, fair market value on date of grant). In that case, shareholders could calculate the maximum amount of compensation that would be attributable to the exercise of options on the basis of their assumptions as to the future stock price. See section 1.162-27(e)(4)(iv).

Based on the facts submitted, and because the amount of compensation to be received by Executive was based solely on the increase in the value of the stock after the date of grant, the number of shares of stock for which options were to be granted to Executive was specifically stated and the requirements of shareholder approval and adequate disclosure were met, we rule that the compensation attributable to the exercise of the option grant by Executive will be considered qualified performance-based compensation within the meaning of section 162(m)(4) of the Code and section 1.162-27(e) on the regulations.

PLR-115188-99

The ruling is based on the condition that at the time of grant of the subject options the compensation committee discussed herein was comprised of two or more "outside directors" as defined in section 1.162-27(e)(3) of the regulations.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent. Except as specifically ruled above, no opinion is expressed as to the federal tax consequences of the transaction described above under any other provisions of the Code.

Sincerely yours,

Robert B. Misner

ROBERT B. MISNER
Assistant Chief, Branch 4
Office of the Associate
Chief Counsel
(Employee Benefits and
Exempt Organizations)

Enclosure:
Copy for section 6110 purposes