OFFICE OF
CHIEF COUNSEL

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

CC:EBEO:Br4

April 5, 1999

UILC: 162.36-00; 162.36-04

Number: **199926030**
Release Date: 7/2/1999

INTERNAL REVENUE SERVICE CHIEF COUNSEL ADVICE

MEMORANDUM FOR

FROM: Assistant Chief Counsel
(Employee Benefits and Exempt Organizations), CC:EBEO

SUBJECT:

This responds to your request for Field Service Advice dated February 3, 1999, regarding whether certain compensation exceeding $1 million can be deducted under section 162(m) of the Internal Revenue Code.

LEGEND:

Company =

Plan A =

Plan B =

Year C =

ISSUES:

1) Whether certain bonuses and awards paid under Plan A and Plan B to Company's four highest compensated officers in Year C qualify under the binding written contract exception to the $1 million limitation on the deduction of compensation under section 162(m) of the Code.

2) Whether the bonuses and awards paid under Plan A and Plan B qualify for the performance-based exception to the $1 million limitation on the deduction of compensation under section 162(m) of the Code.

CONCLUSIONS:

1) The bonuses and awards paid under Plan A and Plan B in Year C appear to satisfy the written binding contract exception to the $1 million limitation on the deduction of compensation under section 162(m).

2) Although a moot point given the above conclusion, the bonuses and awards paid under Plan A and Plan B do not satisfy the performance-based exception to section 162(m) of the Code because the plans were not approved by Company's shareholders and, in the case of Plan A, the performance goals are not objective. The performance goals in Plan A are not objective because the compensation formula includes discretion to increase the amount of compensation that would have been payable on attainment of a goal.

Company appears to agree with the conclusion that the performance-based exception does not apply because in its Year C compensation committee minutes and proxy Company indicates that the plans are not performance based. Also, in a letter dated December 1, 1998, Company's representative only argues that the written binding contract exception applies. Accordingly, this memorandum will only focus on the written binding contract exception.[1]

FACTS:

The following are the facts as we understand them concerning the written binding contract issue. Company is a publicly-held corporation. During Year C, Company had several executive compensation plans in effect, including Plan A and Plan B, both of which became effective and were revised prior to February 17, 1993. In February of Year C, Company paid bonuses under Plan A and Plan B that, together with other compensation paid during the taxable year, exceeded $1,000,000 to each of four executives. Company concedes that bonuses paid under Plan A and

---

[1] The incoming request initially stated that Company contends that the awards and bonuses paid under Plan A and Plan B were performance based. In our view, Company advances this contention as a means of reinforcing its argument that the compensation paid under those awards and grants was paid pursuant to written binding contracts, and perhaps in response to Examination's argument that compensation was not actually paid under the plans because the performance goals were not met. That is, as we suspect Company's response to Examination is: if the compensation was paid under pre-determined, performance-based formulas and not on a wholly discretionary basis, the compensation was paid under written binding contracts.

Plan B did not meet the performance-based exception of section 162(m), but contends that the compensation escapes the deduction limitation of that section because it was paid under binding written contracts.[2]

Examination has requested guidance concerning whether Company's position that compensation paid pursuant to awards and grants under Plans A and B was paid under binding written contracts, as described in section 1.162-27(h)(1) of the Income Tax Regulations, is correct.

Plan A was intended to provide cash incentive awards to certain employees for their efforts to increase corporate growth and profitability. The Executive Compensation Committee (Committee) was responsible for selecting the employees eligible for the award and determining the amount of the award.

Plan A awards were made annually. The amount of an award was based on corporate performance measures, including earnings per share (EPS). Plan A awards are based on pre-established performance measures approved by Committee. No award was earned unless the performance floor for that portion of the award was exceeded; the "guideline bonus opportunity award" was earned if budget-level performance was achieved; and an amount greater or less than 100% of the "guideline bonus opportunity award" could be earned for performance above the performance floor as determined by Committee. Certain individual awards could be adjusted upward or downward, within a range of 80 to 120% of the total "guideline bonus opportunity," to account for demonstrated quality of performance or the occurrence of unusual or unforseen circumstances.

The Plan A awards paid out in Year C covered the previous year's performance period. Prior to January 1 of the year preceding Year C, Committee established the

---

[2] A grandfather clause was included in the regulations for plans that were previously-approved prior to December 20, 1993. Under this clause, a previously-approved plan is considered performance-based even if administered by directors that are not "outside directors" (as required by paragraphs (e)(3) and (e)(4) of section 1.162-27 of the Income Tax Regulations), provided the plan was administered by a "disinterested director" and approved by shareholders in a manner consistent with certain enumerated rules under the Exchange Act of 1934. See section 1.162-27(h)(3). This grandfather rule, however, does not apply unless the plan was otherwise performance-based, and to meet this requirement it would have to meet all the requirements of paragraph (e)(2). Plans A and B do not meet all the requirements of paragraph (e)(2) because, as we held in Conclusion 2 above, they were not approved by Company's shareholders, as was the case with most cash plans in effect prior to the effective date of section 162(m). Also, the terms of Plan A do not preclude discretion to increase the amount of compensation paid that would otherwise be due upon attainment of the performance goal. See section 1.162-27(e)(2)(iii)(A).

maximum guideline bonus opportunity that each of the top executives could earn during the performance period. On or before February 17, 1993, Committee established and approved the specific performance parameters and bonus formulas for these awards. The performance formula assigned different weights to three measures: (1) EPS; (2) Company's net income after adjustments for extraordinary accounting charges; and (3) the increase in Company's revenue over the reported revenues for the year two years prior to Year C. Committee established a floor amount for each factor which had to be met for any bonus to be paid with respect to that factor and a target amount ranging from 0% to 300% for that factor. The bonus would be paid depending on Company's performance with respect to each particular factor. The Committee also had discretion to adjust the formula by an increase of a specified percentage based on a showing of outstanding performance during the year by an individual.

Paragraph 4.F. of Plan A states that Committee may terminate Plan A at any time, to become effective as of January 1 of the following year. It further states that the Committee may alter or amend Plan A at any time provided that no such alteration or amendment impairs the rights of any participant who has been granted an award under Plan A.

For Plan A awards paid in Year C, Company's EPS exceeded the targeted EPS so that, given the net income of Company for the year preceding Year C, a payment of 100% of the targeted bonus was paid based on these two factors. Based on the sliding scale relative to Company's revenue increase, however, there was a slight reduction of the targeted bonuses for this factor. A discretionary factor was applied to make positive individual performance adjustments of 20% per executive. According to Company's representative, the discretionary increase under this factor usually results in a 10-percent increase in the total bonus. At its meeting in February of Year C, Committee reviewed the performance factors and financial results and approved payment of bonuses to Plan A participants applying these calculations. In February of Year C, Company paid the bonuses at issue to Plan A participants.

Turning to Plan B, its purpose was to secure and retain key employees and to motivate those employees through the award of performance units (Units). Certain key employees who were responsible for management, growth, and protection of Company's business (or any of its subsidiaries) could be granted Units. Participants in Plan B were selected, from those employees who are eligible to participate, by Committee. Committee selected the award period for a Unit; however, the award period could not exceed four calendar years. Dollar payment values, performance criteria targets, and targets were established by Committee. Committee could increase or decrease performance criteria, targets, and/or Unit payment schedules if in its sole judgment there were extraordinary occurrences, not anticipated when Units were granted, which significantly affected Company's earnings or other performance criteria. Promptly after the completion of the award period, Committee determined what, if any, award payments were earned with respect to the related Units. Payment was made in cash promptly after the Committee's determination.

Paragraph 7 of Plan B states that Committee may amend or discontinue Plan B, but no amendment or discontinuation shall be made which would impair the rights of a grantee under any Unit previously granted without the grantee's consent.

Plan B bonuses paid in Year C covered the three-year period prior to Year C. Committee established the performance formula in two stages. In December of the year preceding the performance period, Committee established and approved the maximum target bonus that each top executive could earn during this performance cycle. Early in the second year of the performance cycle, Committee approved the cumulative EPS target for the Units granted. Under this formula, a bonus of 100% of the target bonus would be paid if Company had EPS of a specified amount for the performance period. For each specified percentage shortfall off that target EPS, each executive would lose a percentage of the target Unit grant. Company's cumulative EPS for the performance period was less than the targeted goal, so each executive's bonus was reduced. At its meeting early in Year C, Committee reviewed the performance factors and approved payment of bonuses to Plan B participants applying these calculations.

Company's proxy statement includes a Committee report regarding Plan A and Plan B payments made in Year C. This report states that because the actual EPS results for the performance period for payments under Plan A and the performance targets for payments under Plan B were both slightly below the targets established, the bonus payments under Plans A and B were lower than they would have been if targets had been met.

LAW AND ANALYSIS:

Section 162(m)(1) of the Code provides that for any publicly held corporation, no deduction shall be allowed for applicable employee remuneration with respect to any covered employee to the extent that the amount of such remuneration for the taxable year exceeds $1,000,000.

Section 162(m)(4)(D) of the Code provides that the term "applicable employee remuneration" shall not include any remuneration payable under a written binding contract that was in effect on February 17, 1993, and that was not modified thereafter in any material respect before such remuneration is paid.

Section 1.162-27(h)(1)(i) of the regulations provides that the deduction limit does not apply to any compensation payable under a written binding contract that was in effect on February 17, 1993. This exception does not apply unless, under applicable state law, the corporation is obligated to pay the compensation if the employee performs the services. However, the deduction limit does apply to a contract that is renewed after February 17, 1993. A written binding contract that is terminable or cancelable by the corporation after February 17, 1993, without the employee's consent is treated as a new contract as of the date that any such termination or cancellation, if made would be effective.

Section 1.162-27(h)(1)(ii) of the regulations provides that if a compensation plan or arrangement meets the requirements of paragraph (h)(1)(i), the compensation paid to an employee pursuant to the plan or arrangement will not be subject to the deduction limit even though the employee was not eligible to participate in the plan as of February 17, 1993. However, the preceding sentence does not apply unless the employee was employed on February 17, 1993, by the corporation that maintained the plan or arrangement, or the employee had the right to participate in the plan or arrangement under a written binding contract as of that date.

According to section 1.162-27(h)(1)(iii)(A) of the regulations, paragraph (h)(1)(i) does not apply to any written binding contract that is materially modified. A material modification occurs when the contract is amended to increase the amount of compensation payable to the employee. If a binding written contract is materially modified, it is treated as a new contract entered into as of the date of the material modification. Thus, amounts received prior to a material modification are not affected, but amounts received subsequently to the material modification are not treated as paid under a binding written contract described in paragraph (h)(1)(i).

Under section 1.162-27(h)(1)(iii)(C) of the regulations, the adoption of a supplemental contract or agreement that provides for increased compensation or the payment of additional compensation, is a material modification of a binding written contract where the facts and circumstances show that the additional compensation is paid on the basis of substantially the same elements or conditions as the compensation that is otherwise paid under the written binding contract. However, a material modification of a written binding contract does not include a supplemental payment that is equal to or less than a reasonable cost-of-living increase over the payment made in the preceding year under that written binding contract. In addition, a supplemental payment of compensation that satisfies the requirements of qualified performance-based compensation in paragraph (e) will not be treated as a material modification.

The issue here is whether Company was obligated to pay compensation under the awards and grants made prior to Year C. According to Company, it generally does not enter into written employment contracts with its officers and employees. Under New York law, absent an agreement establishing a fixed duration, an employment relationship is presumed to be "at will" employment. In an "at will" employment situation, if an employer's plan promises the employee compensation and the employee relied on the promise, then the plan is binding on the corporation.

DePetris v. Union Settlement Assn., 86 N.Y.2d 406, 410; 633 N.Y.S.2d 274 (1995).

Although the specific details of each executive's employment negotiations are unknown, we assume that the executives relied on the potential bonus compensation when they rendered services for Company in the year or years prior to Year C. Additionally, both plans contain a paragraph indicating that if the plans were amended or terminated, no such amendment or termination could impair the rights of any participant who had previously been granted an award or grant under the plans. Although the exact date is unclear from the submission, Company executives received awards under Plans A and B prior to February 17, 1993. Additionally, Company's submission dated August 25, 1998, indicates that individual employee-specific awards made under Plans A and B were placed in writing. Further, it appears, based on the proxy and statements of Company's representative, that these Company executives performed the necessary services during the performance period because the bonuses were approved by Committee and paid. We note that the proxy statement indicates that the actual EPS results for the performance period for payments under Plan A and the performance targets for payments under Plan B were both slightly below the targets established. We believe this language means that the maximum targets were not met for the maximum bonus, however, the plans contain a sliding scale for measuring the amount of the bonus resulting in a reduced bonus. Because the executives received the awards under Plans A and B prior to February 17, 1993, these awards were placed in writing, and the executives performed the required services during the performance period, we believe payment of bonuses for awards made under Plans A and B was a binding contractual obligation of Company.

Company appears to satisfy the written binding contract exception because both plans were adopted prior to February 17, 1993, awards and grants in general compliance with Plans A and B were made prior to February 17, 1993, and Company appears obligated under state law to pay the compensation if the employees performed the services. Additionally, it does not appear that either of the plans has been materially modified since February 17, 1993, and it does not appear that Company adopted a supplemental contract or agreement for increased or additional compensation. Accordingly, we believe Company satisfies this exception. Because Company satisfies this exception, the limitation of section 162(m) is inapplicable.

If you have any questions about this memorandum, please call (202) 622-6060.

MARY OPPENHEIMER
Assistant Chief Counsel

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