

INTERNAL REVENUE SERVICE

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July 26, 2000.

Company =

date a =

dates b =

date c =

date d =

date e =

date f =

date g =

x =

y percent =

This is in reply to a request for rulings and subsequent correspondence concerning whether the compensation Company paid on date g was "qualified performance-based compensation", and whether Company's officers with respect to a short taxable year are "covered employees".

Company is a publicly held corporation with a fiscal year that historically ended on date a.

Company's performance compensation plan provides for payment of annual performance bonuses to certain executive officers of Company. The plan was timely approved by Company's stockholders. The plan provides that any one of nine stated business criteria can be used in determining performance targets. The plan was established for a term of x fiscal years of Company. Company contends that although the term "fiscal year" is not defined in the plan, the plan was originally intended to extend from dates b.

On date c, the compensation committee of Company's board of directors met to establish the performance targets for the fiscal year ending date d. The performance targets established for the participants included return on equity targets, with increased bonuses available if higher levels of return on equity were achieved. At the time this meeting was scheduled and held, Company and the members of the compensation committee assumed that the fiscal year would end on date a. Payment of these scheduled performance bonuses was made contingent upon satisfaction of the performance targets for that fiscal year.

Shortly after the compensation committee meeting, Company began to consider changing its fiscal year for various business reasons unrelated to taxes. After consideration of the various reasons for changing its fiscal year end to match those of

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its competitors, on date e Company made the final decision to change its fiscal year to end on date f.

In order to accommodate this decision, Company decided to make correlative adjustments and pay performance bonuses on date g, in amounts that were no more than y percent of the originally scheduled bonuses established by the compensation committee. Company has represented that these bonuses will be repaid to Company if the compensation committee determines that the performance goals set for the fiscal year that would have ended on date d are not met.

According to Company, it will not be required to file any official proxy with the Securities Exchange Commission (SEC) for its short year ending on date f of the year prior to this year. Accordingly, no "Summary Compensation Table" listing Company officers will be included in any proxy for this period. Company plans to file with the SEC, on a voluntary basis, a Form 8-K, updating the information on Company's previous Form 10-K, which will reflect compensation paid to Company's top executives for the short year.

Section 162(a)(1) of the Internal Revenue 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 "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 1.162-27(c)(2) of the Income Tax Regulations provides the general rule for who is a covered employee. Under the regulations, a covered employee means any individual who, on the last day of the taxable year, is (A) the chief executive officer of the corporation or is acting in such capacity; or (B) among the four highest compensated officers (other than the chief executive officer). Whether an individual is the chief executive officer or one of the four highest compensated officers is determined pursuant to the executive compensation disclosure rules under the Exchange Act.

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In the notice of proposed rulemaking containing the proposed regulations under section 162(m), the preamble contains the following language concerning the identification of "covered employee":

The regulations clarify which employees are "covered employees" for purposes of section 162(m). The legislative history to section 162(m) provides that "covered employees" are defined by reference to the SEC rules governing executive compensation disclosure under the Exchange Act. Under the regulations, an individual generally is a "covered employee" if the individual's compensation is reported on the "summary compensation table" under the SEC's executive compensation disclosure rules, as set forth in Item 402 of Regulation S-K, 17 CFR 229.402, under the Exchange Act. However, the regulations specifically provide that, in order to be a "covered employee" for section 162(m) purposes, an individual must be employed as an executive officer on the last day of the taxable year. Thus, only those employees who appear on the "summary compensation table" and who are also employed on the last day of the taxable year are "covered employees."

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(e)(2)(i) of the regulations provides, in part, that "qualified performance-based compensation" (the compensation referred to in section 162(m)(4) of the Code) 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

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time the compensation committee actually establishes the goal. However, in no event will a performance goal be considered to be preestablished if it is established after 25 percent of the period of service (as scheduled in good faith at the time the goal is established) has elapsed.

According to section 1.162-27(e)(2)(ii) of the regulations, 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. Such business criteria could include, for example, stock price, market share, sales, earnings per share, return on equity, or costs.

Section 1.162-27(e)(2)(iii) of the regulations provides, in part, that the terms of an objective formula or standard must preclude discretion to increase the amount of compensation payable that would otherwise be due upon attainment of the goal. A performance goal is not discretionary for purposes of this paragraph (e)(2)(iii) merely because the compensation committee reduces or eliminates the compensation or other economic benefit that was due upon attainment of the goal.

Example 13 in section 1.162-27(e)(2)(vii) of the regulations provides the following:

Corporation W adopts a plan under which a bonus will be paid to the CEO only if there is a 10% increase in earnings per share during the performance period. The plan provides that earnings per share will be calculated without regard to any change in accounting standards that may be required by the Financial Accounting Standards Board after the goal is established. After the goal is established, such a change in accounting standards occurs. Corporation W's reported earnings, for purposes of determining earnings per share under the plan, are adjusted pursuant to this plan provision to factor out this change in standards. The adjustment will not be considered an exercise of impermissible discretion because it is made pursuant to the plan provision.

The negative implication from this example 13 is that if a provision in the plan does not call for an adjustment in the performance goals or period in the case of an unforeseen event, such an adjustment would be an exercise of impermissible discretion.

Section 1.162-27(e)(2)(v) of the regulations provides that compensation does not satisfy the requirements of paragraph (e)(2) if the facts and circumstances indicate that the employee would receive all or part of the compensation regardless of whether the performance goal is attained. Thus, if the payment of compensation under an award is partially contingent on attaining a performance goal, none of the compensation payable under the award will be considered performance-based.

Section 1.162-27(e)(5) of the regulations requires the compensation committee to certify in writing prior to payment of the compensation that the performance goals

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and any other material terms were in fact satisfied. For this purpose, approved minutes of the compensation committee meeting in which the certification is made are treated as a written certification.

Under the facts provided in Rev. Rul. 79-311, 1979-2 C.B. 25, advances were made to employees in contemplation of services to be performed in the future. The ruling holds that the advances were income to the employees at the time of payment even though the employees were obligated to repay the advances in the event they failed to perform the future services. However, advances repaid to the employer in the same year in which received were excludable from gross income.

Therefore, based on the facts as outlined above, we rule as follows:

1. The payment to Company's employees under the plan on date g will be "qualified performance-based compensation" provided the performance goals were met for the performance period ending on date d and that the compensation committee certifies that the goals were met.
2. For purposes of section 162(m) of the Code, Company's officers (including the chief executive officer) will not be "covered employees" with respect to the short year ending on date f of the year prior to this year provided that no proxy will be filed by Company for that short year, and accordingly no Summary Compensation Table listing Company officers is required to be filed by Company with the SEC for that short year.

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
Assistant Chief, Executive Compensation Branch
Office of Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities)

Enclosure:

Copy for section 6110 purposes

cc: