

reinforced plastic ladders. The ANSI standard requires specification of the maximum working length of an extension ladder, as well as several other pieces of information not required by the Extension Ladder Rule, including the total length of the ladder's sections and the highest standing level of the ladder. Compliance with the ANSI standard, therefore, ensures compliance with the labeling requirements of the Extension Ladder Rule. Several commenters noted this overlap in coverage of the Extension Ladder Rule and ANSI standard A14, and recommended that the Rule be retained unchanged.

Another commenter stated that the Rule has imposed minor, incremental costs, but opined that the benefits have been significant in that consumers have a better understanding of extension ladder length. The commenter questioned whether there was a continuing need for this Rule given the existence of ANSI standard A14 and UL standard 184, which the commenter stated also requires extension ladders to be marked to indicate both the total length of sections and the maximum extended length or maximum working length.

In addition to these specific comments, one general comment, applicable to several Commission Rules being reviewed, was received from an advertising agency association. This organization recommended rescission of the Extension Ladder Rule because the general prohibitions of Section 5 of the Federal Trade Commission Act covering false and deceptive advertising apply to the ladder industry. Thus, the commenter concluded that the Rule creates unnecessary administrative costs for the government, industry members and consumers.

Commission staff also engaged in an informal review of industry practices by examining the marking of length on extension ladders available for retail sale at several chain stores. That review indicated general compliance with the requirements of the Rule. Additionally, a check of Commission records failed to find any complaints regarding non-compliance with the Rule, or any initiation of law enforcement actions alleging violations of the Rule's requirements.

Accordingly, the Commission has reviewed the rulemaking record and determined to repeal the Extension Ladder Rule due to changes in industry practice, and the existence of industry standards mandating the point-of-sale disclosures required by the Rule.

III. Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA), 5 U.S.C. 601-11, requires an analysis of the anticipated impact of the repeal of the Rule on small businesses. The reasons for repeal of the Rule have been explained in this Notice. Repeal of the Rule would appear to have little or no effect on small businesses. Moreover, the Commission is not aware of any existing federal laws or regulations that would conflict with repeal of the Rule. For these reasons, the Commission certifies, pursuant to Section 605 of the RFA, 5 U.S.C. 605, that this action will not have a significant economic impact on a substantial number of small entities.

IV. Paperwork Reduction Act

The Extension Ladder Rule imposes third-party disclosure requirements that constitute "information collection requirements" under the Paperwork Reduction Act, 44 U.S.C. 3501 *et seq.* Accordingly, repeal of the Rule would eliminate any burdens on the public imposed by these disclosure requirements.

List of Subjects in 16 CFR Part 418

Advertising, Extension ladders, Trade practices.

PART 418—[REMOVED]

The Commission, under authority of Section 18 of the Federal Trade Commission Act, 15 U.S.C. 57a, amends chapter I of title 16 of the Code of Federal Regulations by removing Part 418.

By direction of the Commission.
Donald S. Clark,
Secretary.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 8650]

RIN 1545-AS23

Disallowance of Deductions for Employee Remuneration in Excess of \$1,000,000

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the disallowance of deductions for employee

remuneration in excess of \$1,000,000. The regulations provide guidance to taxpayers that are subject to section 162(m), which was added to the Code by the Omnibus Budget Reconciliation Act of 1993.

DATES: These regulations are effective January 1, 1994.

For dates of applicability, see § 1.162-27(j).

FOR FURTHER INFORMATION CONTACT: Robert Misner or Charles T. Deliee at (202)622-6060 (not a toll free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1466. Responses to these collections of information are required to obtain a tax deduction for performance-based compensation in excess of \$1 million.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The estimated average annual burden per respondent is 50 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

Under section 162(m) of the Internal Revenue Code, a publicly held corporation is denied a deduction for compensation paid to its "covered employees" to the extent the compensation exceeds \$1,000,000 if the compensation would otherwise be deductible in a taxable year beginning on or after January 1, 1994.

On December 20, 1993, proposed regulations under section 162(m) (the 1993 proposed regulations) were published in the Federal Register (58

FR 66310). Amendments to the proposed regulations (the 1994 amendments) were published in the Federal Register on December 2, 1994 (59 FR 61844). Public hearings were held on May 9, 1994, and August 11, 1995. After consideration of the comments that were received in response to the notices of proposed rulemaking and at the hearings, the IRS and Treasury adopt the proposed regulations as amended and revised by this Treasury decision.

Explanation of Provisions

A. Overview of Provisions

As noted above, section 162(m) provides that a publicly held corporation is denied a deduction for compensation paid to a "covered employee" to the extent the compensation exceeds \$1,000,000. A "covered employee" includes the chief executive officer (CEO), as well as any other individual whose compensation is required to be reported to the Securities and Exchange Commission by reason of that individual being among the four highest compensated officers for the taxable year (other than the CEO), as of the end of the corporation's taxable year.

"Performance-based compensation" and certain other compensation is not subject to the deduction limitation of section 162(m). Performance-based compensation is remuneration payable solely on account of the attainment of one or more performance goals, but only if: (1) the goals are determined by a compensation committee of the board of directors consisting solely of two or more outside directors; (2) the material terms under which the compensation is to be paid are disclosed to the shareholders and approved by a majority in a separate vote before payment is made; and (3) before any payment is made, the compensation committee certifies that the performance goals and any other material terms have been satisfied.

Compensation is also excluded from the deduction limitation of section 162(m) if it is paid under a binding written contract that was in existence on February 17, 1993. In addition, in accordance with the legislative history, the proposed regulations exempt from the limitation compensation that is paid under an arrangement that existed before the corporation became publicly held, to the extent that the arrangement is disclosed in the initial public offering.

B. Discussion of Comments

Comments that relate to the application of the proposed regulations and the responses to the comments, including an explanation of the revisions reflected in the final regulations, are summarized below.

Dividend Equivalents Paid on Stock Options

Under the proposed regulations, the performance-based exception to the deduction limitation generally is applied on a grant-by-grant basis. If the facts and circumstances indicate, however, that the employee would receive all or part of the compensation regardless of whether the performance goal is attained, the compensation is not performance based. For example, where payment under a nonperformance based bonus is contingent upon the failure to attain the performance goals under an otherwise performance-based bonus, neither bonus arrangement will be considered performance based. The proposed regulations provide that whether dividends (which generally are not performance based) on restricted stock are payable before attainment of the performance goal, will not affect the determination of whether the restricted stock is performance based. The proposed regulations also provide, however, that if the amount of any compensation the employee will receive under a stock option is not based solely on an increase in the value of the stock after the date of grant (for example, an option granted with an exercise price that is less than the fair market value of the stock as of the date of grant), none of the compensation attributable to the grant will be performance based.

Commentators raised the question of whether nonperformance-based dividend equivalents that are paid with respect to a granted but unexercised stock option irrespective of whether the option is exercised will cause the compensation paid upon the exercise of the option to be nonperformance based. Section 1.162-27(e)(2)(vi) of the final regulations provides that such dividend equivalents will not cause the compensation paid upon the exercise of the option to be nonperformance based, provided that the payment of the dividend equivalents is not conditioned upon the employee exercising the option. If the payment of the dividend equivalent is conditioned upon the employee exercising the option, the dividend effectively reduces the exercise price of the option, thereby causing the option to be nonperformance based upon its exercise.

Bonus Pools

Section 1.162-27(e)(2)(ii) of the proposed regulations provides that 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. A formula or standard is objective if a third party having knowledge of the relevant performance results could calculate the amount to be paid to the employee.

Section 1.162-27(e)(2)(iii) prohibits discretion to increase the amount of compensation to be paid under the preestablished performance goal, but permits the compensation committee to reduce or eliminate the compensation that is due upon attainment of the goal.

Examples 7 and 8 under § 1.162-27(e)(2)(vii) of the proposed regulations illustrated the application of these rules to bonus pools. In Example 7, the amount of the bonus pool was determined under an objective formula. However, because the compensation committee retained the discretion to determine the fraction of the bonus pool that each covered employee would receive, the compensation that any individual could receive was not determined under an objective formula and, therefore, the bonus plan did not satisfy the requirements of paragraph (e)(2). In Example 8, the compensation for any individual was determined under an objective formula because each employee's share of the bonus pool was specified and because, notwithstanding the compensation committee's ability to reduce the compensation payable to each individual employee, a reduction in one employee's bonus would not result in an increase in the amount of any other employee's bonus.

Several commentators have indicated that, in some cases where compensation committees have stated the amount payable to each individual under a bonus pool plan as a percentage of the bonus pool, the total of these percentages has exceeded 100 percent of the pool. The use of such overlapping percentages is inconsistent with § 1.162-27(e)(2), as illustrated by both Example 7 and Example 8. As noted, Example 8 states that negative discretion will not cause the bonus plan to fail to satisfy the requirements of paragraph (e)(2), "provided that a reduction in the amount of one employee's bonus does not result in an increase in the amount of any other employee's bonus." Where the total of the percentages payable under a bonus pool plan exceeds 100 percent, it is impossible to award each individual the

stated percentage, and this necessary exercise of negative discretion with respect to one or more employees means that it is impossible for a third party, with knowledge of the relevant performance results, to calculate the amount to be paid to each employee. Further, a reduction in at least some employees' bonuses will result in an increase in the amount available to pay other employees' bonuses.

Accordingly, § 1.162-27(e)(2)(iii) is amended to state more clearly that, when the compensation to be paid to each employee is stated in terms of a percentage of a bonus pool, the sum of the individual percentages for all participants in the pool cannot exceed 100 percent. In addition, the principle stated in Example 8, that the exercise of negative discretion with respect to one employee cannot increase the amount payable to another employee, is incorporated in paragraph (e)(2)(iii). Example 8 is also revised to more clearly illustrate this rule.

Although the IRS and Treasury believe that the changes made merely clarify the proposed regulations, it is recognized that others have interpreted the language of the proposed regulations differently. Therefore, under § 1.162-27(j)(2)(iv), this clarified rule will not be applied to any compensation paid before January 1, 2001, under a bonus pool based on performance in any period that began before December 20, 1995.

Outside Directors

Section 1.162-27(e)(3)(vi) provides that a director is not precluded from being an outside director solely because he or she is a former officer of a corporation that previously was an affiliated corporation of the publicly held corporation. The regulation is revised to clarify that a former officer of either a spun off or liquidated corporation, that formerly was a member of the affiliated group, is not precluded from serving on the compensation committee of the publicly held member of the affiliated group.

Companies that Become Publicly Held Without an Initial Public Offering

Under § 1.162-27(f), the \$1 million deduction limit does not apply to any compensation plan or agreement that existed before the corporation became publicly held to the extent that the plan or agreement was disclosed in the prospectus accompanying the initial public offering (IPO). This exception may be relied on until the earliest of: (1) the expiration of the plan or agreement, (2) the material modification of the plan or agreement, (3) the issuance of all

stock and other compensation that has been allocated under the plan, or (4) the first shareholder meeting at which directors will be elected that occurs after the close of the third calendar year following the calendar year in which the IPO occurs.

Commentators have asked whether this rule applies to corporations that become publicly held without an IPO.

As indicated in the legislative history accompanying Code section 162(m), the prospectus that accompanies the IPO provides an opportunity to disclose the terms of the plan or agreement to the potential shareholders, and the subsequent purchase of the stock with that knowledge may be viewed as tantamount to a favorable vote on the compensation arrangement. When a corporation becomes publicly held without an IPO, there is no comparable alternative means of satisfying the requirements of section 162(m)(4)(C)(ii). On the other hand, because there is no requirement for privately held corporations to comply with section 162(m), the IRS and Treasury recognize the need for a transition rule for plans and agreements that are in existence when a privately held corporation becomes publicly held without an IPO.

Accordingly, § 1.162-27(f)(1) is revised to provide relief for privately held corporations that become publicly held without an IPO. Under the transition rule for these corporations, the reliance period in § 1.162-27(f)(2) lapses upon the first meeting of shareholders at which directors are to be elected that occurs after the close of the first calendar year following the calendar year in which the corporation becomes publicly held.

Written Binding Contracts

Section 1.162-27(h)(1) provides the transition rules for compensation payable under a written binding contract that was in effect on February 17, 1993. Under those rules, 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. The proposed regulations further provide that, if the terms of a contract provide that the contract will be terminated or canceled as of a certain date unless either the corporation or the employee elects to renew within 30 days of that date, the contract is treated as renewed by the corporation as of that date.

Commentators have suggested that these regulations clarify the outcome where a corporation will remain bound

by the terms of a contract beyond a certain date at the sole discretion of the employee. For example, if a contract that is in effect on February 17, 1993, provides that the employee has the sole discretion to extend or renew the terms beyond its stated expiration, without the consent of the corporation, a question arises whether the contract will be considered a pre-February 17, 1993 written binding contract after the employee chooses to extend.

Generally, the question of whether the terms of a contract are binding is determined under state law. The IRS and Treasury believe that the rules for determining whether a contract is binding should be applied based on whether the corporation is bound by the terms of the contract. Thus, if a contract provides the employee with the right to extend or renew its terms without the consent of the corporation, and the corporation is legally obligated to pay the agreed-upon compensation to the employee if the employee chooses to extend or renew the contract, the contract will be considered binding on the corporation. Accordingly, a new sentence has been added to § 1.162-27(h)(1)(i) to clarify that, if the corporation will remain legally obligated by the terms of a contract beyond a certain date at the sole discretion of the employee, the contract will not be treated as a new contract as of that date if the employee exercises the discretion.

Awards Based on a Percentage of Salary

The 1994 amendments modified § 1.162-27(e)(2)(iii) to provide that, if the terms of an objective formula or standard fail to preclude discretion merely because the amount of compensation to be paid upon attainment of the performance goal is based, in whole or in part, on a percentage of salary or base pay, the objective formula or standard will not be considered discretionary (and thus § 1.162-27(e)(2)(iii) will not be violated) if the maximum dollar amount to be paid is fixed at the time the performance goal is established. The final regulations clarify that a maximum dollar amount need not be specified under this provision if, at the time the performance goal is established, the dollar amount of salary or base pay is fixed. In such a case, the use of salary or base pay does not cause the formula to fail to preclude discretion to increase compensation.

The 1994 amendments made a corresponding amendment with respect to salary-based formulas for the shareholder disclosure rules in § 1.162-27(e)(4)(i). However, the shareholder disclosure amendment was not

explicitly limited to formulas that would otherwise be discretionary. The final regulations clarify that the shareholder disclosure rule relating to salary-based formulas applies only to those formulas that would otherwise be discretionary.

In addition, the final regulations provide transition relief with respect to the 1994 amendment of the shareholder disclosure requirement relating to salary-based formulas. New § 1.162-27(j)(2)(v) provides that this disclosure requirement applies only to plans approved by shareholders after April 30, 1995.

In the case of a preestablished performance goal that was established prior to the publication of the 1994 amendments, a corporation could, of course, rely upon a reasonable good faith interpretation of the statutory provisions to determine that the performance goal was stated in terms of an objective formula, to the extent the issue to which the interpretation relates was not covered by the 1993 regulations. An award made pursuant to such a performance goal would not fail to be performance based merely because the award was made after the publication of the 1994 amendments.

Stock-Based Compensation

The 1993 proposed regulations provided transition relief for previously approved plans and agreements that did not satisfy the written binding contract requirement as of February 17, 1993, but that were approved by shareholders before December 20, 1993. See § 1.162-27(h)(3)(iii). The transition relief applied to compensation paid prior to the expiration of a reliance period. In response to comments on the 1993 proposed regulations, the 1994 amendments expanded this relief to encompass compensation paid after the reliance period with respect to the exercise of stock options and stock appreciation rights, and the substantial vesting of restricted property, provided that the stock option, stock appreciation right, or restricted property was granted during the reliance period. Similar relief provisions were also included in new transition rules added by the 1994 amendments. (See §§ 1.162-27(f)(3), (f)(4), (j)(2)(ii), and (j)(2)(iii) of the final regulations.)

Commentators have asked that the relief provided in the 1994 amendments for stock options, stock appreciation rights, and restricted property be extended even further to cover other stock-based compensation and deferred compensation in general. After careful consideration of the comments received, the IRS and Treasury have concluded

that there is not adequate justification for a further expansion of the 1994 expansion of the prior regulatory transition relief for previously approved plans and agreements, or the other similar relief provisions added in 1994.

Subsidiaries That Become Separate Publicly Held Corporations

Section 1.162-27(f)(4) of the proposed regulations contains special rules for subsidiaries that become separate publicly held corporations. A transition rule set forth in § 1.162-27(i)(2)(iii) of the proposed regulations specified delayed effective dates for these special rules. However, commentators indicated that the regulations were not explicit as to which rules applied prior to the delayed effective dates.

The final regulations clarify that compensation paid prior to the delayed effective dates by a subsidiary that becomes a separate publicly held corporation will not be subject to the \$1 million deduction limit if the conditions of the transition rule are satisfied. (This transition rule and all other effective date provisions have been moved from paragraph (i) to paragraph (j) of the final regulations. Paragraph (i) is reserved.)

Special Analysis

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Charles T. Deliee and Robert Misner, Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations), Internal Revenue Service. However, other personnel from IRS and the Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.162-27 is added to read as follows:

§ 1.162-27 Certain employee remuneration in excess of \$1,000,000.

(a) *Scope.* This section provides rules for the application of the \$1 million deduction limit under section 162(m) of the Internal Revenue Code. Paragraph (b) of this section provides the general rule limiting deductions under section 162(m). Paragraph (c) of this section provides definitions of generally applicable terms. Paragraph (d) of this section provides an exception from the deduction limit for compensation payable on a commission basis. Paragraph (e) of this section provides an exception for qualified performance-based compensation. Paragraphs (f) and (g) of this section provide special rules for corporations that become publicly held corporations and payments that are subject to section 280G, respectively. Paragraph (h) of this section provides transition rules, including the rules for contracts that are grandfathered and not subject to section 162(m). Paragraph (j) of this section contains the effective date provisions. For rules concerning the deductibility of compensation for services that are not covered by section 162(m) and this section, see section 162(a)(1) and § 1.162-7. This section is not determinative as to whether compensation meets the requirements of section 162(a)(1).

(b) *Limitation on deduction.* Section 162(m) precludes a deduction under chapter 1 of the Internal Revenue Code by any publicly held corporation for compensation paid to any covered employee to the extent that the compensation for the taxable year exceeds \$1,000,000.

(c) *Definitions—(1) Publicly held corporation—(i) General rule.* A publicly held corporation means any corporation issuing any class of common equity securities required to be registered under section 12 of the Exchange Act. A corporation is not considered publicly held if the registration of its equity securities is voluntary. For purposes of this section, whether a corporation is

publicly held is determined based solely on whether, as of the last day of its taxable year, the corporation is subject to the reporting obligations of section 12 of the Exchange Act.

(ii) *Affiliated groups.* A publicly held corporation includes an affiliated group of corporations, as defined in section 1504 (determined without regard to section 1504(b)). For purposes of this section, however, an affiliated group of corporations does not include any subsidiary that is itself a publicly held corporation. Such a publicly held subsidiary, and its subsidiaries (if any), are separately subject to this section. If a covered employee is paid compensation in a taxable year by more than one member of an affiliated group, compensation paid by each member of the affiliated group is aggregated with compensation paid to the covered employee by all other members of the group. Any amount disallowed as a deduction by this section must be prorated among the payor corporations in proportion to the amount of compensation paid to the covered employee by each such corporation in the taxable year.

(2) *Covered employee*—(i) *General rule.* 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).

(ii) *Application of rules of the Securities and Exchange Commission.* Whether an individual is the chief executive officer described in paragraph (c)(2)(i)(A) of this section or an officer described in paragraph (c)(2)(i)(B) of this section is determined pursuant to the executive compensation disclosure rules under the Exchange Act.

(3) *Compensation*—(i) *In general.* For purposes of the deduction limitation described in paragraph (b) of this section, *compensation* means the aggregate amount allowable as a deduction under chapter 1 of the Internal Revenue Code for the taxable year (determined without regard to section 162(m)) for remuneration for services performed by a covered employee, whether or not the services were performed during the taxable year.

(ii) *Exceptions.* *Compensation* does not include—

(A) Remuneration covered in section 3121(a)(1) through section 3121(a)(5)(D) (concerning remuneration that is not treated as wages for purposes of the Federal Insurance Contributions Act); and

(B) Remuneration consisting of any benefit provided to or on behalf of an employee if, at the time the benefit is provided, it is reasonable to believe that the employee will be able to exclude it from gross income. In addition, compensation does not include salary reduction contributions described in section 3121(v)(1).

(4) *Compensation Committee.* The *compensation committee* means the committee of directors (including any subcommittee of directors) of the publicly held corporation that has the authority to establish and administer performance goals described in paragraph (e)(2) of this section, and to certify that performance goals are attained, as described in paragraph (e)(5) of this section. A committee of directors is not treated as failing to have the authority to establish performance goals merely because the goals are ratified by the board of directors of the publicly held corporation or, if applicable, any other committee of the board of directors. See paragraph (e)(3) of this section for rules concerning the composition of the compensation committee.

(5) *Exchange Act.* The *Exchange Act* means the Securities Exchange Act of 1934.

(6) *Examples.* This paragraph (c) may be illustrated by the following examples:

Example 1. Corporation X is a publicly held corporation with a July 1 to June 30 fiscal year. For Corporation X's taxable year ending on June 30, 1995, Corporation X pays compensation of \$2,000,000 to A, an employee. However, A's compensation is not required to be reported to shareholders under the executive compensation disclosure rules of the Exchange Act because A is neither the chief executive officer nor one of the four highest compensated officers employed on the last day of the taxable year. A's compensation is not subject to the deduction limitation of paragraph (b) of this section.

Example 2. C, a covered employee, performs services and receives compensation from Corporations X, Y, and Z, members of an affiliated group of corporations. Corporation X, the parent corporation, is a publicly held corporation. The total compensation paid to C from all affiliated group members is \$3,000,000 for the taxable year, of which Corporation X pays \$1,500,000; Corporation Y pays \$900,000; and Corporation Z pays \$600,000. Because the compensation paid by all affiliated group members is aggregated for purposes of section 162(m), \$2,000,000 of the aggregate compensation paid is nondeductible. Corporations X, Y, and Z each are treated as paying a ratable portion of the nondeductible compensation. Thus, two thirds of each corporation's payment will be nondeductible. Corporation X has a nondeductible compensation expense of \$1,000,000 (\$1,500,000×\$2,000,000/\$3,000,000).

Corporation Y has a nondeductible compensation expense of \$600,000 (\$900,000×\$2,000,000/\$3,000,000). Corporation Z has a nondeductible compensation expense of \$400,000 (\$600,000×\$2,000,000/\$3,000,000).

Example 3. Corporation W, a calendar year taxpayer, has total assets equal to or exceeding \$5 million and a class of equity security held of record by 500 or more persons on December 31, 1994. However, under the Exchange Act, Corporation W is not required to file a registration statement with respect to that security until April 30, 1995. Thus, Corporation W is not a publicly held corporation on December 31, 1994, but is a publicly held corporation on December 31, 1995.

Example 4. The facts are the same as in *Example 3*, except that on December 15, 1996, Corporation W files with the Securities and Exchange Commission to disclose that Corporation W is no longer required to be registered under section 12 of the Exchange Act and to terminate its registration of securities under that provision. Because Corporation W is no longer subject to Exchange Act reporting obligations as of December 31, 1996, Corporation W is not a publicly held corporation for taxable year 1996, even though the registration of Corporation W's securities does not terminate until 90 days after Corporation W files with the Securities and Exchange Commission.

(d) *Exception for compensation paid on a commission basis.* The deduction limit in paragraph (b) of this section shall not apply to any compensation paid on a commission basis. For this purpose, compensation is paid on a commission basis if the facts and circumstances show that it is paid solely on account of income generated directly by the individual performance of the individual to whom the compensation is paid. Compensation does not fail to be attributable directly to the individual merely because support services, such as secretarial or research services, are utilized in generating the income. However, if compensation is paid on account of broader performance standards, such as income produced by a business unit of the corporation, the compensation does not qualify for the exception provided under this paragraph (d).

(e) *Exception for qualified performance-based compensation*—

(1) *In general.* The deduction limit in paragraph (b) of this section does not apply to qualified performance-based compensation. Qualified performance-based compensation is compensation that meets all of the requirements of paragraphs (e)(2) through (e)(5) of this section.

(2) *Performance goal requirement*—(i) *Preestablished goal.* 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. 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. 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. A performance goal need not, however, be based upon an increase or positive result under a business criterion and could include, for example, maintaining the status quo or limiting economic losses (measured, in each case, by reference to a specific business criterion). 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. See paragraph (e)(2)(vi) of this section for rules on compensation that is based on an increase in the price of stock.

(ii) *Objective compensation formula.* 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. A formula or standard is objective if a third party having knowledge of the relevant performance results could calculate the amount to be paid to the employee. In addition, a formula or standard must specify the individual employees or class of employees to which it applies.

(iii) *Discretion.*

(A) 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. However, the exercise of negative discretion with respect to one employee is not permitted to result in an increase in the amount payable to another employee. Thus, for example, in the case of a bonus pool, if the amount payable to each employee is stated in terms of a percentage of the pool, the sum of these individual percentages of the pool is not permitted to exceed 100 percent. If the terms of an objective formula or standard fail to preclude discretion to increase the amount of compensation merely because the amount of compensation to be paid upon attainment of the performance goal is based, in whole or in part, on a percentage of salary or base pay and the dollar amount of the salary or base pay is not fixed at the time the performance goal is established, then the objective formula or standard will not be considered discretionary for purposes of this paragraph (e)(2)(iii) if the maximum dollar amount to be paid is fixed at that time.

(B) If compensation is payable upon or after the attainment of a performance goal, and a change is made to accelerate the payment of compensation to an earlier date after the attainment of the goal, the change will be treated as an increase in the amount of compensation, unless the amount of compensation paid is discounted to reasonably reflect the time value of money. If compensation is payable upon or after the attainment of a performance goal, and a change is made to defer the payment of compensation to a later date, any amount paid in excess of the amount that was originally owed to the employee will not be treated as an increase in the amount of compensation if the additional amount is based either on a reasonable rate of interest or on one or more predetermined actual investments (whether or not assets associated with the amount originally owed are actually invested therein) such that the amount payable by the employer at the later date will be based on the actual rate of return of a specific investment (including any decrease as well as any increase in the value of an investment). If compensation is payable in the form of property, a change in the timing of the transfer of that property after the attainment of the goal will not be treated as an increase in the amount of compensation for purposes of this paragraph (e)(2)(iii). Thus, for example, if the terms of a stock grant provide for stock to be transferred after the attainment of a performance goal and the transfer of the stock also is subject to a vesting schedule, a change in the vesting schedule that either accelerates

or defers the transfer of stock will not be treated as an increase in the amount of compensation payable under the performance goal.

(C) Compensation attributable to a stock option, stock appreciation right, or other stock-based compensation does not fail to satisfy the requirements of this paragraph (e)(2) to the extent that a change in the grant or award is made to reflect a change in corporate capitalization, such as a stock split or dividend, or a corporate transaction, such as any merger of a corporation into another corporation, any consolidation of two or more corporations into another corporation, any separation of a corporation (including a spinoff or other distribution of stock or property by a corporation), any reorganization of a corporation (whether or not such reorganization comes within the definition of such term in section 368), or any partial or complete liquidation by a corporation.

(iv) *Grant-by-grant determination.* The determination of whether compensation satisfies the requirements of this paragraph (e)(2) generally shall be made on a grant-by-grant basis. Thus, for example, whether compensation attributable to a stock option grant satisfies the requirements of this paragraph (e)(2) generally is determined on the basis of the particular grant made and without regard to the terms of any other option grant, or other grant of compensation, to the same or another employee. As a further example, except as provided in paragraph (e)(2)(vi), whether a grant of restricted stock or other stock-based compensation satisfies the requirements of this paragraph (e)(2) is determined without regard to whether dividends, dividend equivalents, or other similar distributions with respect to stock, on such stock-based compensation are payable prior to the attainment of the performance goal. Dividends, dividend equivalents, or other similar distributions with respect to stock that are treated as separate grants under this paragraph (e)(2)(iv) are not performance-based compensation unless they separately satisfy the requirements of this paragraph (e)(2).

(v) *Compensation contingent upon attainment of performance goal.* Compensation does not satisfy the requirements of this 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 a grant or award is only nominally or partially contingent on attaining a performance goal, none of the compensation payable under the

grant or award will be considered performance-based. For example, if an employee is entitled to a bonus under either of two arrangements, where payment under a nonperformance-based arrangement is contingent upon the failure to attain the performance goals under an otherwise performance-based arrangement, then neither arrangement provides for compensation that satisfies the requirements of this paragraph (e)(2). Compensation does not fail to be qualified performance-based compensation merely because the plan allows the compensation to be payable upon death, disability, or change of ownership or control, although compensation actually paid on account of those events prior to the attainment of the performance goal would not satisfy the requirements of this paragraph (e)(2). As an exception to the general rule set forth in the first sentence of paragraph (e)(2)(iv) of this section, the facts-and-circumstances determination referred to in the first sentence of this paragraph (e)(2)(v) is made taking into account all plans, arrangements, and agreements that provide for compensation to the employee.

(vi) *Application of requirements to stock options and stock appreciation rights*—(A) *In general.* Compensation attributable to a stock option or a stock appreciation right is deemed to satisfy the requirements of this paragraph (e)(2) if the grant or award is made by the compensation committee; the plan under which the option or right is granted states the maximum number of shares with respect to which options or rights 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. Conversely, if the amount of compensation the employee will receive under the grant or award is not based solely on an increase in the value of the stock after the date of grant or award (e.g., in the case of restricted stock, or an option that is granted with an exercise price that is less than the fair market value of the stock as of the date of grant), none of the compensation attributable to the grant or award is qualified performance-based compensation because it does not satisfy the requirement of this paragraph (e)(2)(vi)(A). Whether a stock option grant is based solely on an increase in the value of the stock after the date of grant is determined without regard to any dividend equivalent that may be payable, provided that payment of the

dividend equivalent is not made contingent on the exercise of the option. The rule that the compensation attributable to a stock option or stock appreciation right must be based solely on an increase in the value of the stock after the date of grant or award does not apply if the grant or award is made on account of, or if the vesting or exercisability of the grant or award is contingent on, the attainment of a performance goal that satisfies the requirements of this paragraph (e)(2).

(B) *Cancellation and repricing.* Compensation attributable to a stock option or stock appreciation right does not satisfy the requirements of this paragraph (e)(2) to the extent that the number of options granted exceeds the maximum number of shares for which options may be granted to the employee as specified in the plan. If an option is canceled, the canceled option continues to be counted against the maximum number of shares for which options may be granted to the employee under the plan. If, after grant, the exercise price of an option is reduced, the transaction is treated as a cancellation of the option and a grant of a new option. In such case, both the option that is deemed to be canceled and the option that is deemed to be granted reduce the maximum number of shares for which options may be granted to the employee under the plan. This paragraph (e)(2)(vi)(B) also applies in the case of a stock appreciation right where, after the award is made, the base amount on which stock appreciation is calculated is reduced to reflect a reduction in the fair market value of stock.

(vii) *Examples.* This paragraph (e)(2) may be illustrated by the following examples:

Example 1. No later than 90 days after the start of a fiscal year, but while the outcome is substantially uncertain, Corporation S establishes a bonus plan under which A, the chief executive officer, will receive a cash bonus of \$500,000, if year-end corporate sales are increased by at least 5 percent. The compensation committee retains the right, if the performance goal is met, to reduce the bonus payment to A if, in its judgment, other subjective factors warrant a reduction. The bonus will meet the requirements of this paragraph (e)(2).

Example 2. The facts are the same as in *Example 1*, except that the bonus is based on a percentage of Corporation S's total sales for the fiscal year. Because Corporation S is virtually certain to have some sales for the fiscal year, the outcome of the performance goal is not substantially uncertain, and therefore the bonus does not meet the requirements of this paragraph (e)(2).

Example 3. The facts are the same as in *Example 1*, except that the bonus is based on a percentage of Corporation S's total profits for the fiscal year. Although some sales are

virtually certain for virtually all public companies, it is substantially uncertain whether a company will have profits for a specified future period even if the company has a history of profitability. Therefore, the bonus will meet the requirements of this paragraph (e)(2).

Example 4. B is the general counsel of Corporation R, which is engaged in patent litigation with Corporation S. Representatives of Corporation S have informally indicated to Corporation R a willingness to settle the litigation for \$50,000,000. Subsequently, the compensation committee of Corporation R agrees to pay B a bonus if B obtains a formal settlement for at least \$50,000,000. The bonus to B does not meet the requirement of this paragraph (e)(2) because the performance goal was not established at a time when the outcome was substantially uncertain.

Example 5. Corporation S, a public utility, adopts a bonus plan for selected salaried employees that will pay a bonus at the end of a 3-year period of \$750,000 each if, at the end of the 3 years, the price of S stock has increased by 10 percent. The plan also provides that the 10-percent goal will automatically adjust upward or downward by the percentage change in a published utilities index. Thus, for example, if the published utilities index shows a net increase of 5 percent over a 3-year period, then the salaried employees would receive a bonus only if Corporation S stock has increased by 15 percent. Conversely, if the published utilities index shows a net decrease of 5 percent over a 3-year period, then the salaried employees would receive a bonus if Corporation S stock has increased by 5 percent. Because these automatic adjustments in the performance goal are preestablished, the bonus meets the requirement of this paragraph (e)(2), notwithstanding the potential changes in the performance goal.

Example 6. The facts are the same as in *Example 5*, except that the bonus plan provides that, at the end of the 3-year period, a bonus of \$750,000 will be paid to each salaried employee if either the price of Corporation S stock has increased by 10 percent or the earnings per share on Corporation S stock has increased by 5 percent. If both the earnings-per-share goal and the stock-price goal are preestablished, the compensation committee's discretion to choose to pay a bonus under either of the two goals does not cause any bonus paid under the plan to fail to meet the requirement of this paragraph (e)(2) because each goal independently meets the requirements of this paragraph (e)(2). The choice to pay under either of the two goals is tantamount to the discretion to choose not to pay under one of the goals, as provided in paragraph (e)(2)(iii) of this section.

Example 7. Corporation U establishes a bonus plan under which a specified class of employees will participate in a bonus pool if certain preestablished performance goals are attained. The amount of the bonus pool is determined under an objective formula. Under the terms of the bonus plan, the compensation committee retains the discretion to determine the fraction of the bonus pool that each employee may receive.

The bonus plan does not satisfy the requirements of this paragraph (e)(2). Although the aggregate amount of the bonus plan is determined under an objective formula, a third party could not determine the amount that any individual could receive under the plan.

Example 8. The facts are the same as in *Example 7*, except that the bonus plan provides that a specified share of the bonus pool is payable to each employee, and the total of these shares does not exceed 100% of the pool. The bonus plan satisfies the requirements of this paragraph (e)(2). In addition, the bonus plan will satisfy the requirements of this paragraph (e)(2) even if the compensation committee retains the discretion to reduce the compensation payable to any individual employee, provided that a reduction in the amount of one employee's bonus does not result in an increase in the amount of any other employee's bonus.

Example 9. Corporation V establishes a stock option plan for salaried employees. The terms of the stock option plan specify that no salaried employee shall receive options for more than 100,000 shares over any 3-year period. The compensation committee grants options for 50,000 shares to each of several salaried employees. The exercise price of each option is equal to or greater than the fair market value at the time of each grant. Compensation attributable to the exercise of the options satisfies the requirements of this paragraph (e)(2). If, however, the terms of the options provide that the exercise price is less than fair market value at the date of grant, no compensation attributable to the exercise of those options satisfies the requirements of this paragraph (e)(2) unless issuance or exercise of the options was contingent upon the attainment of a preestablished performance goal that satisfies this paragraph (e)(2).

Example 10. The facts are the same as in *Example 9*, except that, within the same 3-year grant period, the fair market value of Corporation V stock is significantly less than the exercise price of the options. The compensation committee reprices those options to that lower current fair market value of Corporation V stock. The repricing of the options for 50,000 shares held by each salaried employee is treated as the grant of new options for an additional 50,000 shares to each employee. Thus, each of the salaried employees is treated as having received grants for 100,000 shares. Consequently, if any additional options are granted to those employees during the 3-year period, compensation attributable to the exercise of those additional options would not satisfy the requirements of this paragraph (e)(2). The results would be the same if the compensation committee canceled the outstanding options and issued new options to the same employees that were exercisable at the fair market value of Corporation V stock on the date of reissue.

Example 11. Corporation W maintains a plan under which each participating employee may receive incentive stock options, nonqualified stock options, stock appreciation rights, or grants of restricted Corporation W stock. The plan specifies that

each participating employee may receive options, stock appreciation rights, restricted stock, or any combination of each, for no more than 20,000 shares over the life of the plan. The plan provides that stock options may be granted with an exercise price of less than, equal to, or greater than fair market value on the date of grant. Options granted with an exercise price equal to, or greater than, fair market value on the date of grant do not fail to meet the requirements of this paragraph (e)(2) merely because the compensation committee has the discretion to determine the types of awards (i.e., options, rights, or restricted stock) to be granted to each employee or the discretion to issue options or make other compensation awards under the plan that would not meet the requirements of this paragraph (e)(2). Whether an option granted under the plan satisfies the requirements of this paragraph (e)(2) is determined on the basis of the specific terms of the option and without regard to other options or awards under the plan.

Example 12. Corporation X maintains a plan under which stock appreciation rights may be awarded to key employees. The plan permits the compensation committee to make awards under which the amount of compensation payable to the employee is equal to the increase in the stock price plus a percentage "gross up" intended to offset the tax liability of the employee. In addition, the plan permits the compensation committee to make awards under which the amount of compensation payable to the employee is equal to the increase in the stock price, based on the highest price, which is defined as the highest price paid for Corporation X stock (or offered in a tender offer or other arms-length offer) during the 90 days preceding exercise. Compensation attributable to awards under the plan satisfies the requirements of paragraph (e)(2)(vi) of this section, provided that the terms of the plan specify the maximum number of shares for which awards may be made.

Example 13. 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. This adjustment will not be considered an exercise of impermissible discretion because it is made pursuant to the plan provision.

Example 14. Corporation X adopts a performance-based incentive pay plan with a four-year performance period. Bonuses under the plan are scheduled to be paid in the first year after the end of the performance period (year 5). However, in the second year of the performance period, the compensation committee determines that any bonuses payable in year 5 will instead, for bona fide business reasons, be paid in year 10. The

compensation committee also determines that any compensation that would have been payable in year 5 will be adjusted to reflect the delay in payment. The adjustment will be based on the greater of the future rate of return of a specified mutual fund that invests in blue chip stocks or of a specified venture capital investment over the five-year deferral period. Each of these investments, considered by itself, is a predetermined actual investment because it is based on the future rate of return of an actual investment. However, the adjustment in this case is not based on predetermined actual investments within the meaning of paragraph (e)(2)(iii)(B) of this section because the amount payable by Corporation X in year 10 will be based on the greater of the two investment returns and, thus, will not be based on the actual rate of return on either specific investment.

Example 15. The facts are the same as in *Example 14*, except that the increase will be based on Moody's Average Corporate Bond Yield over the five-year deferral period. Because this index reflects a reasonable rate of interest, the increase in the compensation payable that is based on the index's rate of return is not considered an impermissible increase in the amount of compensation payable under the formula.

Example 16. The facts are the same as in *Example 14*, except that the increase will be based on the rate of return for the Standard & Poor's 500 Index. This index does not measure interest rates and thus does not represent a reasonable rate of interest. In addition, this index does not represent an actual investment. Therefore, any additional compensation payable based on the rate of return of this index will result in an impermissible increase in the amount payable under the formula. If, in contrast, the increase were based on the rate of return of an existing mutual fund that is invested in a manner that seeks to approximate the Standard & Poor's 500 Index, the increase would be based on a predetermined actual investment within the meaning of paragraph (e)(2)(iii)(B) of this section and thus would not result in an impermissible increase in the amount payable under the formula.

(3) *Outside directors*—(i) *General rule.* The performance goal under which compensation is paid must be established by a compensation committee comprised solely of two or more outside directors. A director is an outside director if the director—

- (A) Is not a current employee of the publicly held corporation;
- (B) Is not a former employee of the publicly held corporation who receives compensation for prior services (other than benefits under a tax-qualified retirement plan) during the taxable year;
- (C) Has not been an officer of the publicly held corporation; and
- (D) Does not receive remuneration from the publicly held corporation, either directly or indirectly, in any capacity other than as a director. For this purpose, remuneration includes any payment in exchange for goods or services.

(ii) *Remuneration received.* For purposes of this paragraph (e)(3), remuneration is received, directly or indirectly, by a director in each of the following circumstances:

(A) If remuneration is paid, directly or indirectly, to the director personally or to an entity in which the director has a beneficial ownership interest of greater than 50 percent. For this purpose, remuneration is considered paid when actually paid (and throughout the remainder of that taxable year of the corporation) and, if earlier, throughout the period when a contract or agreement to pay remuneration is outstanding.

(B) If remuneration, other than de minimis remuneration, was paid by the publicly held corporation in its preceding taxable year to an entity in which the director has a beneficial ownership interest of at least 5 percent but not more than 50 percent. For this purpose, remuneration is considered paid when actually paid or, if earlier, when the publicly held corporation becomes liable to pay it.

(C) If remuneration, other than de minimis remuneration, was paid by the publicly held corporation in its preceding taxable year to an entity by which the director is employed or self-employed other than as a director. For this purpose, remuneration is considered paid when actually paid or, if earlier, when the publicly held corporation becomes liable to pay it.

(iii) *De minimis remuneration*—(A) *In general.* For purposes of paragraphs (e)(3)(ii)(B) and (C) of this section, remuneration that was paid by the publicly held corporation in its preceding taxable year to an entity is de minimis if payments to the entity did not exceed 5 percent of the gross revenue of the entity for its taxable year ending with or within that preceding taxable year of the publicly held corporation.

(B) *Remuneration for personal services and substantial owners.* Notwithstanding paragraph (e)(3)(iii)(A) of this section, remuneration in excess of \$60,000 is not de minimis if the remuneration is paid to an entity described in paragraph (e)(3)(ii)(B) of this section, or is paid for personal services to an entity described in paragraph (e)(3)(ii)(C) of this section.

(iv) *Remuneration for personal services.* For purposes of paragraph (e)(3)(iii)(B) of this section, remuneration from a publicly held corporation is for personal services if—

(A) The remuneration is paid to an entity for personal or professional services, consisting of legal, accounting, investment banking, and management consulting services (and other similar

services that may be specified by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin), performed for the publicly held corporation, and the remuneration is not for services that are incidental to the purchase of goods or to the purchase of services that are not personal services; and

(B) The director performs significant services (whether or not as an employee) for the corporation, division, or similar organization (within the entity) that actually provides the services described in paragraph (e)(3)(iv)(A) of this section to the publicly held corporation, or more than 50 percent of the entity's gross revenues (for the entity's preceding taxable year) are derived from that corporation, subsidiary, or similar organization.

(v) *Entity defined.* For purposes of this paragraph (e)(3), entity means an organization that is a sole proprietorship, trust, estate, partnership, or corporation. The term also includes an affiliated group of corporations as defined in section 1504 (determined without regard to section 1504(b)) and a group of organizations that would be an affiliated group but for the fact that one or more of the organizations are not incorporated. However, the aggregation rules referred to in the preceding sentence do not apply for purposes of determining whether a director has a beneficial ownership interest of at least 5 percent or greater than 50 percent.

(vi) *Employees and former officers.* Whether a director is an employee or a former officer is determined on the basis of the facts at the time that the individual is serving as a director on the compensation committee. Thus, a director is not precluded from being an outside director solely because the director is a former officer of a corporation that previously was an affiliated corporation of the publicly held corporation. For example, a director of a parent corporation of an affiliated group is not precluded from being an outside director solely because that director is a former officer of an affiliated subsidiary that was spun off or liquidated. However, an outside director would no longer be an outside director if a corporation in which the director was previously an officer became an affiliated corporation of the publicly held corporation.

(vii) *Officer.* Solely for purposes of this paragraph (e)(3), officer means an administrative executive who is or was in regular and continued service. The term implies continuity of service and excludes those employed for a special and single transaction. An individual

who merely has (or had) the title of officer but not the authority of an officer is not considered an officer. The determination of whether an individual is or was an officer is based on all of the facts and circumstances in the particular case, including without limitation the source of the individual's authority, the term for which the individual is elected or appointed, and the nature and extent of the individual's duties.

(viii) *Members of affiliated groups.* For purposes of this paragraph (e)(3), the outside directors of the publicly held member of an affiliated group are treated as the outside directors of all members of the affiliated group.

(ix) *Examples.* This paragraph (e)(3) may be illustrated by the following examples:

Example 1. Corporations X and Y are members of an affiliated group of corporations as defined in section 1504, until July 1, 1994, when Y is sold to another group. Prior to the sale, A served as an officer of Corporation Y. After July 1, 1994, A is not treated as a former officer of Corporation X by reason of having been an officer of Y.

Example 2. Corporation Z, a calendar-year taxpayer, uses the services of a law firm by which B is employed, but in which B has a less-than-5-percent ownership interest. The law firm reports income on a July 1 to June 30 basis. Corporation Z appoints B to serve on its compensation committee for calendar year 1998 after determining that, in calendar year 1997, it did not become liable to the law firm for remuneration exceeding the lesser of \$60,000 or five percent of the law firm's gross revenue (calculated for the year ending June 30, 1997). On October 1, 1998, Corporation Z becomes liable to pay remuneration of \$50,000 to the law firm on June 30, 1999. For the year ending June 30, 1998, the law firm's gross revenue was less than \$1 million. Thus, in calendar year 1999, B is not an outside director. However, B may satisfy the requirements for an outside director in calendar year 2000, if, in calendar year 1999, Corporation Z does not become liable to the law firm for additional remuneration. This is because the remuneration actually paid on June 30, 1999 was considered paid on October 1, 1998 under paragraph (e)(3)(ii)(C) of this section.

Example 3. Corporation Z, a publicly held corporation, purchases goods from Corporation A. D, an executive and less-than-5-percent owner of Corporation A, sits on the board of directors of Corporation Z and on its compensation committee. For 1997, Corporation Z obtains representations to the effect that D is not eligible for any commission for D's sales to Corporation Z and that, for purposes of determining D's compensation for 1997, Corporation A's sales to Corporation Z are not otherwise treated differently than sales to other customers of Corporation A (including its affiliates, if any) or are irrelevant. In addition, Corporation Z has no reason to believe that these representations are inaccurate or that it is otherwise paying remuneration indirectly to D personally. Thus, in 1997, no remuneration

is considered paid by Corporation Z indirectly to D personally under paragraph (e)(3)(ii)(A) of this section.

Example 4. (i) Corporation W, a publicly held corporation, purchases goods from Corporation T. C, an executive and less-than-5-percent owner of Corporation T, sits on the board of directors of Corporation W and on its compensation committee. Corporation T develops a new product and agrees on January 1, 1998 to pay C a bonus of \$500,000 if Corporation W contracts to purchase the product. Even if Corporation W purchases the new product, sales to Corporation W will represent less than 5 percent of Corporation T's gross revenues. In 1999, Corporation W contracts to purchase the new product and, in 2000, C receives the \$500,000 bonus from Corporation T. In 1998, 1999, and 2000, Corporation W does not obtain any representations relating to indirect remuneration to C personally (such as the representations described in *Example 3*).

(ii) Thus, in 1998, 1999, and 2000, remuneration is considered paid by Corporation W indirectly to C personally under paragraph (e)(3)(ii)(A) of this section. Accordingly, in 1998, 1999, and 2000, C is not an outside director of Corporation W. The result would have been the same if Corporation W had obtained appropriate representations but nevertheless had reason to believe that it was paying remuneration indirectly to C personally.

Example 5. Corporation R, a publicly held corporation, purchases utility service from Corporation Q, a public utility. The chief executive officer, and less-than-5-percent owner, of Corporation Q is a director of Corporation R. Corporation R pays Corporation Q more than \$60,000 per year for the utility service, but less than 5 percent of Corporation Q's gross revenues. Because utility services are not personal services, the fees paid are not subject to the \$60,000 de minimis rule for remuneration for personal services within the meaning of paragraph (e)(3)(iii)(B) of this section. Thus, the chief executive officer qualifies as an outside director of Corporation R, unless disqualified on some other basis.

Example 6. Corporation A, a publicly held corporation, purchases management consulting services from Division S of Conglomerate P. The chief financial officer of Division S is a director of Corporation A. Corporation A pays more than \$60,000 per year for the management consulting services, but less than 5 percent of Conglomerate P's gross revenues. Because management consulting services are personal services within the meaning of paragraph (e)(3)(iv)(A) of this section, and the chief financial officer performs significant services for Division S, the fees paid are subject to the \$60,000 de minimis rule as remuneration for personal services. Thus, the chief financial officer does not qualify as an outside director of Corporation A.

Example 7. The facts are the same as in *Example 6*, except that the chief executive officer, and less-than-5-percent owner, of the parent company of Conglomerate P is a director of Corporation A and does not perform significant services for Division S. If the gross revenues of Division S do not

constitute more than 50 percent of the gross revenues of Conglomerate P for P's preceding taxable year, the chief executive officer will qualify as an outside director of Corporation A, unless disqualified on some other basis.

(4) *Shareholder approval requirement*—(i) *General rule.* 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. The requirements of this paragraph (e)(4) are not satisfied if the compensation would be paid regardless of whether the material terms are approved by shareholders. The material terms include the employees eligible to receive compensation; a description of the business criteria on which the performance goal is based; and either the maximum amount of compensation that could be paid to any employee or the formula used to calculate the amount of compensation to be paid to the employee if the performance goal is attained (except that, in the case of a formula that fails to preclude discretion to increase the amount of compensation (as described in paragraph (e)(2)(iii)(A) of this section) merely because the amount of compensation to be paid is based, in whole or in part, on a percentage of salary or base pay and the dollar amount of the salary or base pay is not fixed at the time the performance goal is established, the maximum dollar amount of compensation that could be paid to the employee must be disclosed).

(ii) *Eligible employees.* Disclosure of the employees eligible to receive compensation need not be so specific as to identify the particular individuals by name. A general description of the class of eligible employees by title or class is sufficient, such as the chief executive officer and vice presidents, or all salaried employees, all executive officers, or all key employees.

(iii) *Description of business criteria*—(A) *In general.* Disclosure of the business criteria on which the performance goal is based need not include the specific targets that must be satisfied under the performance goal. For example, if a bonus plan provides that a bonus will be paid if earnings per share increase by 10 percent, the 10-percent figure is a target that need not be disclosed to shareholders. However, in that case, disclosure must be made that the bonus plan is based on an earnings-per-share business criterion. In the case of a plan under which employees may be granted stock options or stock appreciation rights, no specific description of the business criteria is

required if the grants or awards are based on a stock price that is no less than current fair market value.

(B) *Disclosure of confidential information.* The requirements of this paragraph (e)(4) may be satisfied even though information that otherwise would be a material term of a performance goal is not disclosed to shareholders, provided that the compensation committee determines that the information is confidential commercial or business information, the disclosure of which would have an adverse effect on the publicly held corporation. Whether disclosure would adversely affect the corporation is determined on the basis of the facts and circumstances. If the compensation committee makes such a determination, the disclosure to shareholders must state the compensation committee's belief that the information is confidential commercial or business information, the disclosure of which would adversely affect the company. In addition, the ability not to disclose confidential information does not eliminate the requirement that disclosure be made of the maximum amount of compensation that is payable to an individual under a performance goal. Confidential information does not include the identity of an executive or the class of executives to which a performance goal applies or the amount of compensation that is payable if the goal is satisfied.

(iv) *Description of compensation.* 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.

(v) *Disclosure requirements of the Securities and Exchange Commission.* To the extent not otherwise specifically provided in this paragraph (e)(4), whether the material terms of a

performance goal are adequately disclosed to shareholders is determined under the same standards as apply under the Exchange Act.

(vi) *Frequency of disclosure.* Once the material terms of a performance goal are disclosed to and approved by shareholders, no additional disclosure or approval is required unless the compensation committee changes the material terms of the performance goal. If, however, the compensation committee has authority to change the targets under a performance goal after shareholder approval of the goal, material terms of the performance goal must be disclosed to and reapproved by shareholders no later than the first shareholder meeting that occurs in the fifth year following the year in which shareholders previously approved the performance goal.

(vii) *Shareholder vote.* For purposes of this paragraph (e)(4), the material terms of a performance goal are approved by shareholders if, in a separate vote, a majority of the votes cast on the issue (including abstentions to the extent abstentions are counted as voting under applicable state law) are cast in favor of approval.

(viii) *Members of affiliated group.* For purposes of this paragraph (e)(4), the shareholders of the publicly held member of the affiliated group are treated as the shareholders of all members of the affiliated group.

(ix) *Examples.* This paragraph (e)(4) may be illustrated by the following examples:

Example 1. Corporation X adopts a plan that will pay a specified class of its executives an annual cash bonus based on the overall increase in corporate sales during the year. Under the terms of the plan, the cash bonus of each executive equals \$100,000 multiplied by the number of percentage points by which sales increase in the current year when compared to the prior year. Corporation X discloses to its shareholders prior to the vote both the class of executives eligible to receive awards and the annual formula of \$100,000 multiplied by the percentage increase in sales. This disclosure meets the requirements of this paragraph (e)(4). Because the compensation committee does not have the authority to establish a different target under the plan, Corporation X need not redisclose to its shareholders and obtain their reapproval of the material terms of the plan until those material terms are changed.

Example 2. The facts are the same as in *Example 1* except that Corporation X discloses only that bonuses will be paid on the basis of the annual increase in sales. This disclosure does not meet the requirements of this paragraph (e)(4) because it does not include the formula for calculating the compensation or a maximum amount of compensation to be paid if the performance goal is satisfied.

Example 3. Corporation Y adopts an incentive compensation plan in 1995 that will pay a specified class of its executives a bonus every 3 years based on the following 3 factors: increases in earnings per share, reduction in costs for specified divisions, and increases in sales by specified divisions. The bonus is payable in cash or in Corporation Y stock, at the option of the executive. Under the terms of the plan, prior to the beginning of each 3-year period, the compensation committee determines the specific targets under each of the three factors (i.e., the amount of the increase in earnings per share, the reduction in costs, and the amount of sales) that must be met in order for the executives to receive a bonus. Under the terms of the plan, the compensation committee retains the discretion to determine whether a bonus will be paid under any one of the goals. The terms of the plan also specify that no executive may receive a bonus in excess of \$1,500,000 for any 3-year period. To satisfy the requirements of this paragraph (e)(4), Corporation Y obtains shareholder approval of the plan at its 1995 annual shareholder meeting. In the proxy statement issued to shareholders, Corporation Y need not disclose to shareholders the specific targets that are set by the compensation committee. However, Corporation Y must disclose that bonuses are paid on the basis of earnings per share, reductions in costs, and increases in sales of specified divisions. Corporation Y also must disclose the maximum amount of compensation that any executive may receive under the plan is \$1,500,000 per 3-year period. Unless changes in the material terms of the plan are made earlier, Corporation Y need not disclose the material terms of the plan to the shareholders and obtain their reapproval until the first shareholders' meeting held in 2000.

Example 4. The same facts as in *Example 3*, except that prior to the beginning of the second 3-year period, the compensation committee determines that different targets will be set under the plan for that period with regard to all three of the performance criteria (i.e., earnings per share, reductions in costs, and increases in sales). In addition, the compensation committee raises the maximum dollar amount that can be paid under the plan for a 3-year period to \$2,000,000. The increase in the maximum dollar amount of compensation under the plan is a changed material term. Thus, to satisfy the requirements of this paragraph (e)(4), Corporation Y must disclose to and obtain approval by the shareholders of the plan as amended.

Example 5. In 1998, Corporation Z establishes a plan under which a specified group of executives will receive a cash bonus not to exceed \$750,000 each if a new product that has been in development is completed and ready for sale to customers by January 1, 2000. Although the completion of the new product is a material term of the performance goal under this paragraph (e)(4), the compensation committee determines that the disclosure to shareholders of the performance goal would adversely affect Corporation Z because its competitors would be made aware of the existence and timing of its new

product. In this case, the requirements of this paragraph (e)(4) are satisfied if all other material terms, including the maximum amount of compensation, are disclosed and the disclosure affirmatively states that the terms of the performance goal are not being disclosed because the compensation committee has determined that those terms include confidential information, the disclosure of which would adversely affect Corporation Z.

(5) *Compensation committee certification.* The compensation committee must certify in writing prior to payment of the compensation that the performance goals 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. Certification by the compensation committee is not required for compensation that is attributable solely to the increase in the stock of the publicly held corporation.

(f) *Companies that become publicly held, spinoffs, and similar transactions—(1) In general.* In the case of a corporation that was not a publicly held corporation and then becomes a publicly held corporation, the deduction limit of paragraph (b) of this section does not apply to any remuneration paid pursuant to a compensation plan or agreement that existed during the period in which the corporation was not publicly held. However, in the case of such a corporation that becomes publicly held in connection with an initial public offering, this relief applies only to the extent that the prospectus accompanying the initial public offering disclosed information concerning those plans or agreements that satisfied all applicable securities laws then in effect. In accordance with paragraph (c)(1)(ii) of this section, a corporation that is a member of an affiliated group that includes a publicly held corporation is considered publicly held and, therefore, cannot rely on this paragraph (f)(1).

(2) *Reliance period.* Paragraph (f)(1) of this section may be relied upon until the earliest of—

(i) The expiration of the plan or agreement;

(ii) The material modification of the plan or agreement, within the meaning of paragraph (h)(1)(iii) of this section;

(iii) The issuance of all employer stock and other compensation that has been allocated under the plan; or

(iv) The first meeting of shareholders at which directors are to be elected that occurs after the close of the third calendar year following the calendar year in which the initial public offering

occurs or, in the case of a privately held corporation that becomes publicly held without an initial public offering, the first calendar year following the calendar year in which the corporation becomes publicly held.

(3) *Stock-based compensation.*

Paragraph (f)(1) of this section will apply to any compensation received pursuant to the exercise of a stock option or stock appreciation right, or the substantial vesting of restricted property, granted under a plan or agreement described in paragraph (f)(1) of this section if the grant occurs on or before the earliest of the events specified in paragraph (f)(2) of this section.

(4) *Subsidiaries that become separate publicly held corporations*—(i) *In general.* If a subsidiary that is a member of the affiliated group described in paragraph (c)(1)(ii) of this section becomes a separate publicly held corporation (whether by spinoff or otherwise), any remuneration paid to covered employees of the new publicly held corporation will satisfy the exception for performance-based compensation described in paragraph (e) of this section if the conditions in either paragraph (f)(4)(ii) or (f)(4)(iii) of this section are satisfied.

(ii) *Prior establishment and approval.* Remuneration satisfies the requirements of this paragraph (f)(4)(ii) if the remuneration satisfies the requirements for performance-based compensation set forth in paragraphs (e)(2), (e)(3), and (e)(4) of this section (by application of paragraphs (e)(3)(viii) and (e)(4)(viii) of this section) before the corporation becomes a separate publicly held corporation, and the certification required by paragraph (e)(5) of this section is made by the compensation committee of the new publicly held corporation (but if the performance goals are attained before the corporation becomes a separate publicly held corporation, the certification may be made by the compensation committee referred to in paragraph (e)(3)(viii) of this section before it becomes a separate publicly held corporation). Thus, this paragraph (f)(4)(ii) requires that the outside directors and shareholders (within the meaning of paragraphs (e)(3)(viii) and (e)(4)(viii) of this section) of the corporation before it becomes a separate publicly held corporation establish and approve, respectively, the performance-based compensation for the covered employees of the new publicly held corporation in accordance with paragraphs (e)(3) and (e)(4) of this section.

(iii) *Transition period.* Remuneration satisfies the requirements of this

paragraph (f)(4)(iii) if the remuneration satisfies all of the requirements of paragraphs (e)(2), (e)(3), and (e)(5) of this section. The outside directors (within the meaning of paragraph (e)(3)(viii) of this section) of the corporation before it becomes a separate publicly held corporation, or the outside directors of the new publicly held corporation, may establish and administer the performance goals for the covered employees of the new publicly held corporation for purposes of satisfying the requirements of paragraphs (e)(2) and (e)(3) of this section. The certification required by paragraph (e)(5) of this section must be made by the compensation committee of the new publicly held corporation. However, a taxpayer may rely on this paragraph (f)(4)(iii) to satisfy the requirements of paragraph (e) of this section only for compensation paid, or stock options, stock appreciation rights, or restricted property granted, prior to the first regularly scheduled meeting of the shareholders of the new publicly held corporation that occurs more than 12 months after the date the corporation becomes a separate publicly held corporation. Compensation paid, or stock options, stock appreciation rights, or restricted property granted, on or after the date of that meeting of shareholders must satisfy all requirements of paragraph (e) of this section, including the shareholder approval requirement of paragraph (e)(4) of this section, in order to satisfy the requirements for performance-based compensation.

(5) *Example.* The following example illustrates the application of paragraph (f)(4)(ii) of this section:

Example. Corporation P, which is publicly held, decides to spin off Corporation S, a wholly owned subsidiary of Corporation P. After the spinoff, Corporation S will be a separate publicly held corporation. Before the spinoff, the compensation committee of Corporation P, pursuant to paragraph (e)(3)(viii) of this section, establishes a bonus plan for the executives of Corporation S that provides for bonuses payable after the spinoff and that satisfies the requirements of paragraph (e)(2) of this section. If, pursuant to paragraph (e)(4)(viii) of this section, the shareholders of Corporation P approve the plan prior to the spinoff, that approval will satisfy the requirements of paragraph (e)(4) of this section with respect to compensation paid pursuant to the bonus plan after the spinoff. However, the compensation committee of Corporation S will be required to certify that the goals are satisfied prior to the payment of the bonuses in order for the bonuses to be considered performance-based compensation.

(g) *Coordination with disallowed excess parachute payments.* The

\$1,000,000 limitation in paragraph (b) of this section is reduced (but not below zero) by the amount (if any) that would have been included in the compensation of the covered employee for the taxable year but for being disallowed by reason of section 280G. For example, assume that during a taxable year a corporation pays \$1,500,000 to a covered employee and no portion satisfies the exception in paragraph (d) of this section for commissions or paragraph (e) of this section for qualified performance-based compensation. Of the \$1,500,000, \$600,000 is an excess parachute payment, as defined in section 280G(b)(1) and is disallowed by reason of that section. Because the excess parachute payment reduces the limitation of paragraph (b) of this section, the corporation can deduct \$400,000, and \$500,000 of the otherwise deductible amount is nondeductible by reason of section 162(m).

(h) *Transition rules*—(1)

Compensation payable under a written binding contract which was in effect on February 17, 1993—(i) *General rule.* The deduction limit of paragraph (b) of this section does not apply to any compensation payable under a written binding contract that was in effect on February 17, 1993. The preceding sentence does not apply unless, under applicable state law, the corporation is obligated to pay the compensation if the employee performs services. However, the deduction limit of paragraph (b) of this section 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. Thus, for example, if the terms of a contract provide that it will be automatically renewed as of a certain date unless either the corporation or the employee gives notice of termination of the contract at least 30 days before that date, the contract is treated as a new contract as of the date that termination would be effective if that notice were given. Similarly, for example, if the terms of a contract provide that the contract will be terminated or canceled as of a certain date unless either the corporation or the employee elects to renew within 30 days of that date, the contract is treated as renewed by the corporation as of that date. Alternatively, if the corporation will remain legally obligated by the terms of a contract beyond a certain date at the sole discretion of the employee, the

contract will not be treated as a new contract as of that date if the employee exercises the discretion to keep the corporation bound to the contract. A contract is not treated as terminable or cancelable if it can be terminated or canceled only by terminating the employment relationship of the employee.

(ii) *Compensation payable under a plan or arrangement.* If a compensation plan or arrangement meets the requirements of paragraph (h)(1)(i) of this section, the compensation paid to an employee pursuant to the plan or arrangement will not be subject to the deduction limit of paragraph (b) of this section 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.

(iii) *Material modifications.*

(A) Paragraph (h)(1)(i) of this section will 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 by an employee under the contract prior to a material modification are not affected, but amounts received subsequent to the material modification are not treated as paid under a binding, written contract described in paragraph (h)(1)(i) of this section.

(B) A modification of the contract that accelerates the payment of compensation will be treated as a material modification unless the amount of compensation paid is discounted to reasonably reflect the time value of money. If the contract is modified to defer the payment of compensation, any compensation paid in excess of the amount that was originally payable to the employee under the contract will not be treated as a material modification if the additional amount is based on either a reasonable rate of interest or one or more predetermined actual investments (whether or not assets associated with the amount originally owed are actually invested therein) such that the amount payable by the employer at the later date will be based on the actual rate of return of the specific investment (including any

decrease as well as any increase in the value of the investment).

(C) 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) of this section will not be treated as a material modification.

(iv) Examples. The following examples illustrate the exception of this paragraph (h)(1):

Example 1. Corporation X executed a 3-year compensation arrangement with C on February 15, 1993, that constitutes a written binding contract under applicable state law. The terms of the arrangement provide for automatic extension after the 3-year term for additional 1-year periods, unless the corporation exercises its option to terminate the arrangement within 30 days of the end of the 3-year term or, thereafter, within 30 days before each anniversary date. Termination of the compensation arrangement does not require the termination of C's employment relationship with Corporation X. Unless terminated, the arrangement is treated as renewed on February 15, 1996, and the deduction limit of paragraph (b) of this section applies to payments under the arrangement after that date.

Example 2. Corporation Y executed a 5-year employment agreement with B on January 1, 1992, providing for a salary of \$900,000 per year. Assume that this agreement constitutes a written binding contract under applicable state law. In 1992 and 1993, B receives the salary of \$900,000 per year. In 1994, Corporation Y increases B's salary with a payment of \$20,000. The \$20,000 supplemental payment does not constitute a material modification of the written binding contract because the \$20,000 payment is less than or equal to a reasonable cost-of-living increase from 1993. However, the \$20,000 supplemental payment is subject to the limitation in paragraph (b) of this section. On January 1, 1995, Corporation Y increases B's salary to \$1,200,000. The \$280,000 supplemental payment is a material modification of the written binding contract because 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 and it is greater than a reasonable, annual cost-of-living increase. Because the written binding contract is materially modified as of January 1, 1995, all compensation paid to B in 1995 and thereafter is subject to the deduction limitation of section 162(m).

Example 3. Assume the same facts as in *Example 2*, except that instead of an increase in salary, B receives a restricted stock grant subject to B's continued employment for the balance of the contract. The restricted stock grant is not a material modification of the binding written contract because any additional compensation paid to B under the grant is not paid on the basis of substantially the same elements and conditions as B's salary because it is based both on the stock price and B's continued service. However, compensation attributable to the restricted stock grant is subject to the deduction limitation of section 162(m).

(2) *Special transition rule for outside directors.* A director who is a disinterested director is treated as satisfying the requirements of an outside director under paragraph (e)(3) of this section until the first meeting of shareholders at which directors are to be elected that occurs on or after January 1, 1996. For purposes of this paragraph (h)(2) and paragraph (h)(3) of this section, a director is a disinterested director if the director is disinterested within the meaning of Rule 16b-3(c)(2)(i), 17 CFR 240.16b-3(c)(2)(i), under the Exchange Act (including the provisions of Rule 16b-3(d)(3), as in effect on April 30, 1991).

(3) *Special transition rule for previously-approved plans—(i) In general.* Any compensation paid under a plan or agreement approved by shareholders before December 20, 1993, is treated as satisfying the requirements of paragraphs (e)(3) and (e)(4) of this section, provided that the directors administering the plan or agreement are disinterested directors and the plan was approved by shareholders in a manner consistent with Rule 16b-3(b), 17 CFR 240.16b-3(b), under the Exchange Act or Rule 16b-3(a), 17 CFR 240.16b-3(a) (as contained in 17 CFR part 240 revised April 1, 1990). In addition, for purposes of satisfying the requirements of paragraph (e)(2)(vi) of this section, a plan or agreement is treated as stating a maximum number of shares with respect to which an option or right may be granted to any employee if the plan or agreement that was approved by the shareholders provided for an aggregate limit, consistent with Rule 16b-3(b), 17 CFR 250.16b-3(b), on the shares of employer stock with respect to which awards may be made under the plan or agreement.

(ii) *Reliance period.* The transition rule provided in this paragraph (h)(3)

shall continue and may be relied upon until the earliest of—

(A) The expiration or material modification of the plan or agreement;

(B) The issuance of all employer stock and other compensation that has been allocated under the plan; or

(C) The first meeting of shareholders at which directors are to be elected that occurs after December 31, 1996.

(iii) *Stock-based compensation.* This paragraph (h)(3) will apply to any compensation received pursuant to the exercise of a stock option or stock appreciation right, or the substantial vesting of restricted property, granted under a plan or agreement described in paragraph (h)(3)(i) of this section if the grant occurs on or before the earliest of the events specified in paragraph (h)(3)(ii) of this section.

(iv) *Example.* The following example illustrates the application of this paragraph (h)(3):

Example. Corporation Z adopted a stock option plan in 1991. Pursuant to Rule 16b-3 under the Exchange Act, the stock option plan has been administered by disinterested directors and was approved by Corporation Z shareholders. Under the terms of the plan, shareholder approval is not required again until 2001. In addition, the terms of the stock option plan include an aggregate limit on the number of shares available under the plan. Option grants under the Corporation Z plan are made with an exercise price equal to or greater than the fair market value of Corporation Z stock. Compensation attributable to the exercise of options that are granted under the plan before the earliest of the dates specified in paragraph (h)(3)(ii) of this section will be treated as satisfying the requirements of paragraph (e) of this section for qualified performance-based compensation, regardless of when the options are exercised.

(i) *(Reserved)*

(j) *Effective date—(1) In general.* Section 162(m) and this section apply to compensation that is otherwise deductible by the corporation in a taxable year beginning on or after January 1, 1994.

(2) *Delayed effective date for certain provisions—(i) Date on which remuneration is considered paid.* Notwithstanding paragraph (j)(1) of this section, the rules in the second sentence of each of paragraphs (e)(3)(ii)(A), (e)(3)(ii)(B), and (e)(3)(ii)(C) of this section for determining the date or dates on which remuneration is considered paid to a director are effective for taxable years beginning on or after January 1, 1995. Prior to those taxable years, taxpayers must follow the rules in paragraphs (e)(3)(ii)(A), (e)(3)(ii)(B), and (e)(3)(ii)(C) of this section or another reasonable, good faith interpretation of section 162(m) with respect to the date

or dates on which remuneration is considered paid to a director.

(ii) *Separate treatment of publicly held subsidiaries.* Notwithstanding paragraph (j)(1) of this section, the rule in paragraph (c)(1)(ii) of this section that treats publicly held subsidiaries as separately subject to section 162(m) is effective as of the first regularly scheduled meeting of the shareholders of the publicly held subsidiary that occurs more than 12 months after December 2, 1994. The rule for stock-based compensation set forth in paragraph (f)(3) of this section will apply for this purpose, except that the grant must occur before the shareholder meeting specified in this paragraph (j)(2)(ii). Taxpayers may choose to rely on the rule referred to in the first sentence of this paragraph (j)(2)(ii) for the period prior to the effective date of the rule.

(iii) *Subsidiaries that become separate publicly held corporations.* Notwithstanding paragraph (j)(1) of this section, if a subsidiary of a publicly held corporation becomes a separate publicly held corporation as described in paragraph (f)(4)(i) of this section, then, for the duration of the reliance period described in paragraph (f)(2) of this section, the rules of paragraph (f)(1) of this section are treated as applying (and the rules of paragraph (f)(4) of this section do not apply) to remuneration paid to covered employees of that new publicly held corporation pursuant to a plan or agreement that existed prior to December 2, 1994, provided that the treatment of that remuneration as performance-based is in accordance with a reasonable, good faith interpretation of section 162(m). However, if remuneration is paid to covered employees of that new publicly held corporation pursuant to a plan or agreement that existed prior to December 2, 1994, but that remuneration is not performance-based under a reasonable, good faith interpretation of section 162(m), the rules of paragraph (f)(1) of this section will be treated as applying only until the first regularly scheduled meeting of shareholders that occurs more than 12 months after December 2, 1994. The rules of paragraph (f)(4) of this section will apply as of that first regularly scheduled meeting. The rule for stock-based compensation set forth in paragraph (f)(3) of this section will apply for purposes of this paragraph (j)(2)(iii), except that the grant must occur before the shareholder meeting specified in the preceding sentence if the remuneration is not performance-based under a reasonable, good faith interpretation of section 162(m).

Taxpayers may choose to rely on the rules of paragraph (f)(4) of this section for the period prior to the applicable effective date referred to in the first or second sentence of this paragraph (j)(2)(iii).

(iv) *Bonus pools.* Notwithstanding paragraph (j)(1) of this section, the rules in paragraph (e)(2)(iii)(A) that limit the sum of individual percentages of a bonus pool to 100 percent will not apply to remuneration paid before January 1, 2001, based on performance in any performance period that began prior to December 20, 1995.

(v) *Compensation based on a percentage of salary or base pay.* Notwithstanding paragraph (j)(1) of this section, the requirement in paragraph (e)(4)(i) of this section that, in the case of certain formulas based on a percentage of salary or base pay, a corporation disclose to shareholders the maximum dollar amount of compensation that could be paid to the employee, will apply only to plans approved by shareholders after April 30, 1995.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 3. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

§ 602.101 [Amended]

Par. 4. In § 602.101, paragraph (c) is amended by adding the entry “1.162-27. . . . 1545-1466” in numerical order to the table.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved: December 12, 1995.

Leslie Samuels,

Assistant Secretary of the Treasury.

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26 CFR Part 1

[TD 8635]

RIN 1545-AS92

Nonbank Trustee Net Worth Requirements

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains regulations that provide guidance to nonbank trustees with respect to the adequacy of net worth requirements that must be satisfied in order to be or