Stock Options Can Ease the Impact of the RRA '93 $1 Million compensation Cap

PRACTICE AREAS

Benefits & Compensation

Executive Compensation

William Sollee, Sr. and Rosina B. Barker

Journal of Taxation

January 1, 1994

ROSINA B. BARKER is an associate and WILLIAM L. SOLLEE, JR. is a member of the Washington, D.C., law firm of Ivins, Phillips & Barker. Chartered, and both specialize in employee benefits law. Mr. Sollee is co-editor of this department, and has written and lectured extensively in this area. ***Structuring compensation to include performance-based options may be the route for some employers, but many areas will require additional guidance.***

Section 162(m), added by the Revenue Reconciliation Act of 1993 (RRA '93) places a $1 million cap on the deductible compensation that can be paid to certain "executives" of publicly traded corporations. This new restriction should make nonqualified stock options[1] a particularly attractive form of executive compensation, for several reasons:

(1.) Options structured to qualify as "performance-based" compensation under the new provision are-like other performance-based compensation-exempt from the cap, and do not count towards the $1 million limit.

(2.) Relative to other forms of performance-based compensation, options give the corporation somewhat more flexibility and discretion.

(3.) Even if options are not performance-based, they still give the employer some ability to avoid the consequences of the cap.

Nevertheless, Section 162(m) and its legislative history raise more questions than they answer about the prospective treatment of options.

HOW THE CAP WORKS

A publicly held corporation[2] can no longer deduct remuneration in excess of $1 million paid to "covered employees." This includes the CEO or an employee other than the CEO whose compensation must be reported to the SEC because that employee is among the four highest-paid officers (other than the CEO) for the tax year.[3]

By its terms, Section 162(m) does not apply to employees of a publicly held corporation's subsidiaries. Thus, a corporation with a holding company structure technically may be able to escape the application of the limitation. It is possible, however, that the statute will be corrected or that Regulations will attempt to read a controlled group test into Section 162(m).

Remuneration. Under Section 162(m)(4), "remuneration" includes the aggregate of all compensation that (without this provision) would be deductible for the year. This generally includes all cash and the cash value of all otherwise deductible noncash compensation and benefits.[4] Compensation is not counted towards the $1 million cap, however, even though otherwise deductible by the employer corporation, if it is:

- Qualified pension plan contributions (including elective or salary reduction contributions). 5
- Excludable benefits (e.g., health benefits and miscellaneous fringe benefits excludable under Section 132).
- Compensation payable on a commission basis.
- Performance-based compensation, if certain outside director and shareholder approval requirements are met (discussed below).
- Compensation paid under a transition rule. Compensation is grandfathered under this rule only if payable under a written binding contract in effect on 2/17/93 and all times thereafter, and not materially modified after that date

The $1 million cap is reduced (but not below zero) by the value of any "excess parachute" payments nondeductible under Section 280G . Thus, if a covered employee receives an excess parachute payment of $750,000, the employee's cap for that year would be $250,000.

Performance-Based Compensation. To qualify as performance-based compensation, remuneration must satisfy certain standards:

- Performance goal. The compensation must be paid solely on account of the attainment of at least one performance goal. The goal must be an "objective" standard that precludes employer discretion, e.g., increases in stock price, market share, sales, or earnings per share.[6]

- Outside director approval. The performance goals must be set by a compensation committee consisting solely of two or more "outside directors."
- Shareholder disclosure and approval. The material terms of the arrangement, including the performance goals, must have been disclosed to and approved by the shareholders before the compensation is paid.
- Certification. Before the compensation is paid, the compensation committee must certify that the performance goals were satisfied, except in the case of stock options and certain other stock-based compensation

Section 83 override? Technically speaking, it appears that Section 162(m) may not deny a deduction when compensation is payable in property and is therefore subject to Section 83. Section 83(h) provides that "there shall be allowed ... a deduction under section 162," indicating that the former provision rather than the latter is the statutory source of the employer's deduction.[7] At least one commentator agrees with this conclusion, stating broadly that " Section 83(h) controls all aspects of the employer's deduction for the compensation income generated by 83(a)-the allowability, the amount, and the timing."[8] The Service agreed with this position in the past, 9 but presumably will seriously reconsider its view.[10]

Effective date. With the exception of the transition rule noted above. Section 162(m) is effective for amounts that otherwise would be deductible for tax years beginning after 1993. 11

PERFORMANCE-BASED OPTIONS

As noted, performance-based compensation is attractive because it is exempt from the Section 162(m) cap and does not count towards the $1 million ceiling. Performance-based stock options and stock appreciation rights (SARs) (collectively, PBOs) may be a particularly attractive form of performance-based compensation for three reasons.

(1.) Flexibility. For other forms of performance-based compensation, the shareholders must approve the exact amounts awarded. For PBOs, however, shareholder approval is required only for the maximum number of shares subject to option that may be granted-the compensation committee may decide to award less. Absent IRS guidance, it is unclear whether shareholder approval must be given with respect to the maximum number of shares that may be granted to any executive, or under the entire plan. In either case, the shareholder approval requirement leaves the compensation committee more discretion than with respect to non-PBO compensation. Many boards of directors prefer that the compensation committee retain some flexibility, so that compensation granted can more accurately reflect actual executive performance. Thus, additional compensation could be withheld if, for example, a profitability target is attained one year for reasons unrelated to the efforts of management, such as conditions favorably affecting the entire industry.

(2.) Other discretion. PBOs may possibly permit discretion on the part of the compensation committee that goes beyond the number of shares that may be awarded. This feature is uncertain, however, as will be discussed further below.

(3.) Certification. PBOs are not required to be certified by outside directors with respect to attainment of a performance goal. Thus, their qualification as performance-based compensation is relatively certain after shareholder approval.

To qualify as PBOs, options must satisfy requirements relating to the performance goal, outside director approval, and shareholder disclosure and approval.

Performance goal. An option or SAR is not based on the attainment of a performance goal if "dependent on factors other than corporate performance."[12] As illustrated in legislative history, this language apparently means that an option is not a PBO if it retains value although the price of the stock subject to option falls below its price on the date of option grant. For example, an option is not a PBO if the exercise price on the date of grant is less than the FMV of the stock on that date (an "in-the-money" option). Similarly, the option is not a PBO if the optionee is protected from a fall in the value of the stock, such as through automatic re-pricing.[13]

It is not clear whether the option fails to qualify as a PBO if the optionee is protected from a fall in the price of the optioned stock under all circumstances. For example, may the option plan provide for repricing if share prices fall because of stock splits, stock dividends or other recapitalizations, or because of a corporate reorganization? The answer should be no.

Another issue concerns what is meant by "fair market value." Is the common meaning of FMV to be used (i.e., the willing buyer, willing seller rule), or is the Section 83 meaning to be applied? 14 Congress added Section 422(c)(7) to mandate that a Section 83 -type definition be applied for incentive stock option (ISO) purposes because of adverse case law.[15] If the common meaning of the term applies, arrangements like junior stock options and career shares plans[16] may be resurrected, especially if the Financial Accounting Standards Board (FASB) proposals mandating an accounting charge for stock options are adopted.[17]

Outside director approval. Like other performance-based compensation, PBOs must be approved by a committee composed entirely of "outside" directors. For this purpose, an outside director is one who is not:

(1.) A current employee of the corporation (or related entities).
(2.) A former employee of the corporation (or related entities) receiving compensation for prior services, other than payments from a qualified plan, or a former officer of the corporation (or related entities).
(3.) Currently receiving compensation for personal services in any capacity (e.g., for services as a consultant) other than as a director.[18]

The scope of this last restriction is unclear. On the one hand, the provision seems likely to preclude lawyers, accountants, investment bankers, venture capitalists and other professional service providers from qualifying as "outside directors" if they or their firms are receiving compensation from the corporation for personal services.[19] On the other hand, does the requirement that the director not receive compensation in "any" capacity mean that the individual cannot be affiliated in any respect with a company that itself receives compensation for services? For example, could an officer of a telecommunications company be an "outside" director under Section 162(m) with respect to a corporation that purchased those telecommunications services?

Shareholder disclosure and approval. Like other performance-based compensation, PBOs must be disclosed to shareholders and approved by a majority of shares voting in a separate vote.[20]

Disclosure. Disclosure must be "adequate." It is not entirely clear what this means. At the very least, it includes revealing to the shareholders those elements of the plan that must be specifically approved, i.e., (1) the terms of the plan, (2) the class of executives covered, (3) the option price or the formula under which the option price is determined, and (4) the maximum number of shares subject to option that can be awarded to any executive.[21]

In addition, Congress directed the Treasury to take into account SEC regulations governing disclosure in defining adequacy for this purpose.[22] SEC disclosure requirements for option grants are fairly detailed. Features of an option or SAR required to be revealed after grant include:

(1.) The grant date value of the option or SAR using an option valuation formula (such as the Black-Scholes formula), or potential values of the options assuming 5% and 10% annualized rates of appreciation in the underlying stock.[23]
(2.) The "material terms" of the option or SAR, including a price adjustment feature (other than anti-dilution provisions); tandem option features; tax reimbursement or "gross-up" provisions; reload features (options reissued at a lower price after a fall in price of the underlying shares); and performance-based conditions on exercise.[24]
(3.) Any indexing features, including any indexing formula and economic assumptions used therein.[25]

Clearly, not all of these would be appropriate for Section 162(m) reporting purposes. Features such as price adjustments, tandem options, and indexing formulas are likely to disqualify the option or SAR as a PBO (as discussed further below). The grant date value would be hard to report before the actual grant, although conceivably the compensation committee could be required to report the valuation formula on which such value would be based.

Other conditions of an option plan, however, clearly could be disclosed, such as "gross-up" provisions and performance preconditions for exercise. Does this mean that all additional rights and conditions of the plan must be disclosed? The RRA '93 Conference Report further muddies this question by providing that "[i]t is intended that not all the details of a plan (or agreement) need be disclosed in all cases.... It is expected that shareholders will, at a minimum, be made aware of the general performance goals on which the executive's compensation is based and the maximum amount that could be paid to the executive if such performance goals were met."[26]

The requirement to disclose "general performance goals" is apparently satisfied automatically for Section 162(m) purposes, since the option's ultimate value depends on the objective measurement of increases in stock value.[27] Does this mean that only additional features that could add to the value of the option (gross-up provisions, for example) must be disclosed? This question becomes especially important in trying to decide how much flexibility the compensation committee should leave itself setting forth the terms of the option plan (discussed below). The more specific the required disclosure, of course, the less flexibility the committee will have in interpreting the plan, or in exercising discretionary authority.

Approval. As noted above, shareholders must approve (1) the specific terms of the PBO plan; (2) the class of executives to which it applies; (3) the option price (or formula under which the price is determined); and (4) the maximum number of shares subject to the option that can be awarded under the plan to any executive.

In the case of performance-based compensation other than PBOs, shareholder approval must be granted with respect to the exact amount of compensation awarded to an executive or class of executives. No director discretion is permitted, even to reduce the compensation below the approved level. In the case of PBOs, however, any number of options may be granted to any executive in the plan so long as the ceiling approved by the shareholders with respect to the individual executive is not exceeded.[28]

When disclosure and approval required. Shareholder approval is required before "payment" of the compensation.[29] Does "payment" occur at the time of grant, or later (e.g., when the option becomes exercisable or when it is actually exercised)? Under Section 83, a PBO is taxable to the employee and deductible to the employer only when it is exercised.[30] Arguably, payment of the option occurs in the year it is exercised and deducted under Section 83(h),

because that section contains a cross-reference to Section 162, which permits a deduction in the year an amount is "paid or incurred." That is, the amount of the option is arguably not "paid or incurred" until exercise (the deduction event). On the other hand, as noted above, it is arguable that Section 83(h) overrides Section 162 altogether. Treasury personnel have informally indicated that this construction of the statute is being considered. Under this view, Section 83 gives no guidance on what amounts are paid or incurred.

SEC executive compensation reporting requirements do not provide more guidance on this question. These rules require initial disclosure in the year following the year of grant of the option.[31] Thus, the Section 162(m) reporting requirements apparently do not track the timing of the SEC reporting requirements. For purposes of section 16 of the Securities Exchange Act of 1934, however, the grant of a stock option is treated as the ownership of the underlying security. The implication is that the grant of the option is considered as the payment of compensation.

Like the question of how much disclosure is required, the question of when shareholder approval is required is especially relevant when considering how much flexibility the compensation committee may have with respect to PBO grants. If shareholder approval is not required until immediately before the option is exercised, it is possible that the compensation committee may have more scope in designing options at their grant. For example, if shareholder approval is not required until exercise of the option, it is possible the employer can effectively "reset" the price of options to follow the market down by granting options at various option prices and submitting for approval only those options granted at the optimal option price.

The question of when an option is "paid" comes up again in the transition rule. Arguably, the modification or cancellation of a plan voids the transition rule only for options "paid" after this event. The meaning of "payment" thus significantly affects the category of options subject to the transition rule.

MATERIAL MODIFICATIONS

If there are material modifications to the plan, shareholder approval must again be obtained in order for options under the plan to qualify as PBOs. Neither Section 162(m) nor the legislative history defines "material modifications" for this purpose.

Nevertheless, the concept of modification arises with respect to statutory options under Section 424. 32 Section 424(h)(1) provides that the "modification, extension or renewal" of an option is equivalent to granting a new option. Under Section 424(h)(3), a modification is a change in the option terms that gives the optionee additional benefits under the option, and considerable IRS guidance has fleshed out this definition. As a first step, it would be reasonable to

assume that material modifications to a PBO for Section 162(m) purposes might include at least those changes that are modifications to an option plan under Section 424(h)(3).

The meaning of modification for purposes of the $1 million cap, however, may be broader than the Section 424(h)(3) definition: as used in Section 162(m), the term is not limited to changes that confer additional benefits on the optionee. Accordingly, categories of changes traditionally held by the Service not to be modifications under Section 424(h)(3) should be examined to see if they might be modifications under Section 162(m).

Changes giving additional benefits. There are four types of alterations that generally are modifications under Section 424(h)(3).

(1.) Terms of stock purchase. Reg. 1.424-1(e)(5)(i) provides that any changes in the terms of the option that make it easier for the optionee to purchase the optioned stock are modifications for purposes of Section 424(h)(3). Modifications of this sort include:

- () A reduction in the minimum number of shares required to be bought on exercise.[33]
- () An extension of the period during which the option may be exercised, such as an extension to allow exercise after retirement.[34]
- () A new employer program permitting the optionee to exercise the option and simultaneously sell the shares subject to option on the open market, essentially providing for a cashless option exercise.[35]
- () Creation of a loan program to finance the exercise of options.3[6]
- () Provision of the right to tender previously acquired stock in settlement of the exercise price.[37]
- () Provision of additional benefits on exercise of the option, such as payment of a cash bonus.3[8]

(2.) Terms of underlying stock. A plan amendment changing the terms of the stock subject to options may be a modification, at least to the extent it applies to unexercised options. 39

(3.) Adjustment due to fall in price of optioned stock. To the optionee, the most significant change in an option may be the reduction in option price to reflect a fall in the underlying share price. Generally, a reduction in option price is a modification under Section 424 , unless specifically excepted by statute or Regulation. 40

(4.) Significance of initial plan terms. To be a modification for Section 424(h)(3) purposes, an adjustment must be

a "change" giving the optionee "additional" benefits. The Service has construed this to mean that changes made possible by the original terms of the plan are not modifications. Conversely, if the original terms of the plan contain many specific restrictions, adjustments otherwise permitted by the Code may be impermissible modifications. For example, an employee's election (at the discretion of the compensation committee) to pay the exercise price of the option by delivery of a promissory note is not a modification where the original terms of the plan provide for such an election. 41 By contrast, however, payment of the option price by promissory note is a modification where the original terms of the plan contemplate only cash payment. 42 Similarly, adjustment in the number and price of shares subject to option to reflect a stock split is a modification under Section 424(h)(3) where the terms of the plan specifically bar a price adjustment in these circumstances, 43 even though under Reg. 1.425-1(e)(5)(ii)(a) the change would not be a modification absent such a provision in the plan terms.

Changes that are not modifications under section 424. The more problematic category of changes in an option plan are those that are not modifications under Section 424(h)(3) , either because (1) the Service has determined they do not confer additional benefits on the optionee, or (2) Congress has legislatively decreed that they are not modifications for this purpose. Can any of these changes can be expected to be exempt from the category of modifications for Section 162(m) purposes?

(1.) Stock dividends and stock splits. Even though "modification" under Section 162(m) includes more than just those changes conferring a benefit on the optionee, the sensible rule under that section with respect to stock splits and dividends would appear to reach the same result as under Section 424(h)(3). To the extent attributable to the stock dividend or stock split, the decline in stock value does not reflect a diminishment of shareholder value. Thus, the price change is not a substantive change, and should not be a modification for Section 162(m).

(2.) Other recapitalizations. Under Section 424(h) , distributions that in any way change the underlying value of the shares under option are likely to be modifications conferring a benefit on the optionee. For example, if share prices fall because of a distribution of cash and debentures to shareholders, any modification of the number or price of shares subject to option is a "benefit" to optionees because it changes their position relative to that of other shareholders.[44] A change in option price reflecting a distribution of assets thus may disqualify the option as a PBO.

(3.) Corporate reorganizations. A similar question arises with respect to option price adjustments, or issuance of new options, to reflect a fall in stock price caused by a spin-off or other corporate reorganization. Section 424 and the Regulations suggest a reasonable answer is that such changes should not be modifications under Section 162(m) (at least to the extent they are not modifications under the special rules of Section 424).[45] While this is a statutory rule, rather than the Service's determination that a change in these circumstances does not confer a

benefit on the optionee, Congress's apparent intent in enacting this provision as part of the Revenue Act of 1964 was to limit price changes to situations where the optionee would receive no additional benefit.[46]

(4.) Anti-dilution features. SEC requirements provide that price adjustments in the option to reflect anti-dilution provisions are not required to be reported to shareholders.[47] SEC regulations are silent, however, on whether actual anti-dilution price adjustments result in the grant of a new option, as do other price adjustments.[48] The Service has apparently not ruled on whether such price adjustments are "modifications" under Section 424 .

(5.) Acceleration in exercisability. Under Section 424(h)(3), in the case of an option "not immediately exercisable in full," an acceleration of the time at which the option may be exercised is not a modification. Congress's intent in adding this provision to the Code as part of the Revenue Act of 1964 was to make it easier for the holder of an option exercisable in installments to "follow the market down" in periods of falling stock prices.[49] IRS has interpreted the provision liberally.[50] Guidance under Section 162(m), however, could construe an acceleration of the exercise period of the option as a modification, notwithstanding Section 424(h)(3)(C) and guidance thereunder. Not only is it a change, but acceleration can confer significant benefits on the optionee. For this reason, IRS guidance before the Revenue Act of 1964 specifically provided that acceleration of the exercise period was a modification.[51] Moreover, the benefit intended by acceleration-to shelter the optionee from a fall in price of the optioned shares-is one that is specifically singled out by the RRA '93 legislative history as a prohibited feature of PBOs.[52]

(6.) Employer's exercise of discretion. The IRS has generally held that the employer's exercise of discretionary authority in an option plan is not a modification under Section 424(h)(3) , as long as the scope of the employer's discretion is spelled out in the plan. For example, where the option plan requires employees to make regular contributions to a plan to cover the option exercise price, but also gives the employer discretionary authority to forgive up to six months of payments on a finding of hardship, the employer's exercise of its discretion is not a modification.[53]

Does this mean that the compensation committee can leave itself additional flexibility for Section 162(m) purposes by giving itself discretion in the terms of the option plan approved by shareholders? The answer is not entirely clear. In the first place, there is some possibility that for Section 424 purposes the Service has retreated from its position that the employer's exercise of discretion is not a modification. Specifically, Prop. Reg. 1.425-1(e), issued in 1984, provides that a change in the plan by which the optionee can receive future benefits at the discretion of the grantor "is a modification both at the time the option is changed and at the time the benefit is actually granted." Read broadly, this implies that the exercise of discretion itself is a modification. The issuance of later guidance (e.g., Ltr. Ruls. 8537010 and 8645024) providing that the exercise of discretion is not a modification suggests this reading may be too broad. Nonetheless, the principle in the Section 424 Proposed Regulations is

there for application to Section 162(m) if the Service wishes to take it.

More to the point, the RRA '93 Conference Report provides that compensation does not satisfy the performance goal requirement unless the compensation is "paid to the particular executive pursuant to a preestablished objective performance formula or standard that precludes discretion."[54] Generally, it seems that if the compensation committee is given discretionary authority by the terms of the plan, compensation awarded thereunder is disqualified as performance-based compensation.

In the case of PBOs, the compensation committee is permitted at least some greater degree of flexibility. The Conference Report states that the rule precluding discretion applies to compensation "other than stock options or other stock appreciation rights."[55] The report goes on specifically to provide however, that the compensation committee has flexibility with respect to the number of options that may be granted to an executive (as long as the maximum number of options that the individual may receive in a specified period is "predetermined," i.e., approved by shareholders).[56] It is not entirely clear whether this is intended as the exclusive province of the committee's discretionary authority, or merely one instance of it.

(7.) Authority to interpret plan. While providing that the compensation committee cannot have "discretion" in interpreting the plan, the Conference Report further provides that "[d]iscretion does not exist merely because the outside directors have the authority to interpret a compensation plan, agreement, or contract in accordance with its terms."[57] It is not clear what this language is intended to accomplish. Perhaps it should be read in light of the further statement in the Report, quoted above in the text accompanying Note 26, with respect to disclosure to shareholders of the maximum amount that might be paid to an executive.

Does this imply that the committee can in effect provide itself discretionary authority by making the plan terms themselves general (or even vague) and then exercising its authority to interpret the plan? This tactic arguably poses less risk of disqualifying the arrangement as a PBO plan than providing explicit discretion. Such a conclusion, however, entails a number of risks. First, the degree of vagueness permitted in a plan is limited by the Section 162(m) disclosure requirements. While these requirements are themselves uncertain, a violation risks disqualifying the plan as a PBO. Second, the conclusion depends on the hope that the Service will respect the compensation committee's interpretation of the option plan. If it does not, such interpretations may be modifications for Section 162(m) purposes. Judging from past practice, IRS may not defer to the compensation committee's interpretation of the plan. It has held that there was no modification where the plan provided for exercise on termination of employment, but the employer construing the terms of the option decided that transfer of the optionee to an affiliated corporation was not a termination of employment. The Service also held, however, that there was no termination of employment in this circumstance; that is,

IRS apparently did not give any deference to the employer's interpretation of its own plan. 58 By the same token, an employer's interpretation has been held to be a modification under Section 424(h)(3) if the Service did not agree with it. 59 In short, the Service's apparent position is that if the employer's interpretation of the plan is correct, it will not be a modification of the plan.

Thus, a compensation committee wishing to leave itself flexibility in administration of a PBO plan has a number of choices. It can build discretion into the terms of the plan, and risk disqualifying the arrangement as a PBO plan. Alternatively, it can leave open the terms of the plan and give itself the authority to interpret the plan. The latter risks (1) a finding that the Section 162(m) shareholder disclosure requirements are not satisfied or (2) a finding that Section 162(m) modifications have occurred requiring shareholder approval.

RESETTING THE OPTION PRICE

On grant of the option, the optionee bears the risk that the price of the optioned stock will fall below the option price, making the option valueless. The Conference Report specifically provides that if the executive is protected from decreases in the value of the stock (such as through automatic repricing), the option fails to qualify as a PBO.[60] Given this provision, is there any way to protect the optionee from a fall in the price of the optioned stock by resetting the exercise price of options to "follow the market down"?

The Conference Report states that the plan must disclose to shareholders either the option price of PBOs issued under the plan, or the formula under which the option price is determined.[61] Thus, a plan providing for issuance of options with an option price equal to the market value of the optioned stock on the date of grant would satisfy this requirement.

New option grant. The simplest tactic is to issue new options after a fall in stock price, with the option price set at the new share price on the date of grant. This strategy involves two risks-that the grant of new options may be impossible without exceeding the shareholder-approved limit on shares subject to option, and that IRS guidance under Section 162(m) could adopt a sequential exercise rule such as that applicable to qualified stock options under prior Section 422(b)(5) . 62 Under this rule, a previously granted qualified or restricted stock option must lapse or be exercised before a later-issued option could be exercised. Congress's purpose in enacting this rule was to make it more difficult to reset the option price to follow the falling price of the optioned share. 63 The Service accordingly might believe it has authority in the RRA '93 legislative history to write a similar sequential exercise rule for PBOs under Section 162(m).

Tandem options. For similar reasons, an employer's attempts to reset the option price in a falling market by issuing tandem options is likely to be invalid under Section 162(m) . As defined for Section 424 purposes, a tandem option is the separate grant, either simultaneously or at different times, of stock options that provide that the exercise of one option reduces the number of shares for which the other option can be exercised.[64] For example, if share prices fall after the grant of an option, the employer might grant new options at a new, reduced option price, that are exercisable only to the extent the previously issued options are not exercised.

A grant of this kind obviously would not increase the number of shares subject to option, and thus would not risk violating the shareholder-approved ceiling required by Section 162(m) . Long-standing IRS guidance, however, holds that the issuance of tandem options is a "modification" for purposes of Sections 422 and 424 , because it frustrates Congressional intent that option prices not be reset to follow the market down.6[5] The Service might follow this guidance to hold that tandem options frustrate similar Congressional intent underlying Section 162(m) . Thus, the issuance of tandem options may be a modification requiring shareholder consent under Section 162(m) . This outcome is made even more likely by SEC compensation disclosure regulations requiring that any adjustment in the option price, "whether through amendment, cancellation or replacement grants or any other means," be reported to shareholders as a new option grant, at the new option price.[66]

For Section 162(m) purposes, the issuance of tandem options might be more than a "modification" requiring shareholder consent. Even if the compensation committee agreed to an issuance of options with tandem option features and obtained shareholder consent after required disclosure, such options might fail to qualify as PBOs. Rev. Rul. 73-26, 1973-1 CB 204 , states that, "[g]iven a tandem feature, it is immaterial whether purported separate options are granted at the same time or at different times; whether purported separate options are granted under the same or under different "plans"; whether the option prices of the two options are the same or different or whether the options are exercisable simultaneously or only consecutively."

Analogously, for Section 162(m) the Service might hold that the issuance of any tandem option after initial issuance is a prohibited feature sheltering the optionee from a fall in share price, and thus sufficient to disqualify the arrangement as a PBO.

Cancellation and replacement of options. Cancellation of previous options, and subsequent reissuance of new options, may not avoid the restrictions of Section 162(m) . In Rev. Rul. 61-219, 1961-2 CB 107 , the Service held that when a corporation granted a stock option, rescinded it before its expiration date, and granted new options with an option price at the new, lower price of the corporation's stock, the grant was a modification and extension of the old option under then-applicable Section 421(e)(1)(A) (and thus was treated as a new option).[67] As with tandem options, a

cancellation of the old option and replacement with a new one may be not only a modification of the option under Section 162(m) (as under former Section 421(e)(1)(A)), but also an event sufficient to disqualify the replacement options as PBOs.

NON-PBO STOCK OPTIONS

To avoid the Section 162(m) cap entirely, an employer might wish to consider issuing PBOs, as discussed above. Even stock options that do not qualify as PBOs might be useful for mitigating the effect of the cap on deductible compensation, however, because of the rather uneven fit between SEC's compensation disclosure regulations and the timing rules of Section 162(m).

Under SEC regulations presently in effect, for compensation reporting purposes an individual's status as CEO or one of the four highest-paid executive officers for a fiscal year is determined at the end of the year. Thus, if an officer terminates service before the end of the year and receives, for example, $2 million of deferred compensation and $5 million of parachute payments the day after termination of service (or on any day in the year), such compensation will not be subject to the $1 million cap.

Proposed amendments to SEC regulations, however, would change the end-of-year rule. 68 Under proposed modifications, individuals subject to SEC compensation reporting requirements for a fiscal year would include:

- Any CEO for that year.
- The four highest-paid individuals who were executive officers at the end of the last completed fiscal year.
- Up to two additional individuals for whom disclosure would have been provided (as being among the top four) but for the fact that the individual was not an executive officer as of the end of the year.

As written, Section 162(m) would not impose the $1 million cap on all officers subject to compensation disclosure under the SEC's proposed modification. Section 162(m) affects only the individual who is CEO at the end of the fiscal year, plus the four highest-paid officers (other than the CEO) during the year. Thus, in any year in which there are changes in the identity of the CEO and four highest-paid executive officers, Section 162(m) would affect only the end-of-year CEO, plus the four highest-paid officers out of the four to six officers (in addition to the CEO) subject to SEC reporting. Of course, if the SEC modifications are adopted, a technical correction might be made to conform Section 162(m).

In any event, employers trying to avoid the $1 million cap should be careful how their deferred compensation agreements (including any non-PBO option agreements) are worded. Even under the proposed SEC modifications, any compensation deferred until the first year in which the employee is no longer subject to SEC compensation disclosure should successfully avoid the cap.

SECTION 162(M) TRANSITION RULE

Compensation is grandfathered from the $1 million cap under Section 162(m) only if payable under a written binding contract in effect on 2/17/93 and all times thereafter, and not materially modified after that date. The transition rule raises many unanswered questions about its applicability.

It is not clear what is meant by a "binding" contract. It is fairly certain that a contract that may be unilaterally cancelled by either party, or materially modified with respect to compensation accrued for services already performed, is not binding. What about a contract that contains employer discretion as to significant features (for example, number of options granted, conditions of exercise, restrictions on optioned stock)? The legislative history hints that such a contract might not be a binding contract.[69]

Treasury personnel have suggested informally that the presence of discretion in a plan will not disqualify it as a binding contract for purposes of the transition rule. The exercise of such discretion, however, will undo the status of the contract as binding. This possible position is consistent with Prop. Reg. 1.425-1(c)(5)(i) , which provides that both the new grant of discretion and the exercise of discretion are "modifications" for Section 424 purposes. But is not clear how such a rule would be applied where the plan had no "default" provisions, i.e., where any action by the compensation committee is an exercise of discretion.

As with the general rule, it is not entirely clear what a "modification" means for purposes of the transition rule. The term raises the same questions as discussed above as to the meaning of "modification" for purposes of when new shareholder approval is required. Does the exercise of "discretion" constitute a modification if the discretion is built into the original option terms? As the immediately preceding paragraph notes, Treasury personnel suggest the answer is yes, but the application of this rule may be difficult.

If there is a material modification, or an exercise of discretion or cancellation invalidating the contract, it is not clear what effect this will have on options granted before the disqualifying event. The Conference Report states that the grandfather rule does not apply "to amounts paid after there has been a material modification to the terms of the contract" (emphasis added).[70] If the term "payment" denotes option grant, previously granted but unexercised options should still qualify under the transition rule.

In addition, the Conference Report goes on to state that a contract that can be cancelled unilaterally "is treated as a new contract entered into on the date any such termination or cancellation, if made, would be effective."[71] This suggests that the contract is not considered cancelled until the actual cancellation event (if any), and that options granted before such event will come under the transition rule. If this is indeed the rule, then "material modification" should invalidate the transition rule only for options granted after the modification. This rule would be consistent with Treasury personnel's informal position on the effect of the exercise of discretion.

1

Statutory stock options-that is, incentive stock options under Section 422 and employee stock options under Section 423 -are unaffected by the new limitation on deductible compensation, because they are not deductible in any case. Section 421(a)(2) .

2

A corporation is publicly held if it has a class of common stock that is required to be registered under section 12 of the Securities Exchange Act of 1934. Neither foreign corporations that voluntarily register nor corporations that register under other sections are covered. The status of the corporation at the time the deduction is to be taken is determinative. Section 162(m)(2) .

3

SEC regulations require disclosure for the CEO and the employer corporation's four highest-paid executive officers (other than the CEO) as of the end of the last fiscal year. The four top-paid officers are identified for this purpose as the four individuals with the highest amount of combined annual "salary and bonus" earned for that year. 17 CFR Section 228.402 (SEC Regulation S-K), Instruction 1 to Item 402(a)(2): and Executive Summary of Regulation S-K, 57 Fed. Reg. 48126, 48129 (10/21/92).

4

H. Rep't No. 103-213, 103d Cong., 1st Sess. 585 (1993) (Conference Report).

5

Id. at 586.

6

Id.

7

This makes eminent sense, since an employer is entitled to a deduction under Section 83(h) even when the all-events test is clearly not met. For example, if property (e.g., stock) that will be forfeited if the employee does not work for a period of time (e.g., three years) is transferred to an employee who has elected to be taxed immediately under Section 83(b) , Reg. 1.83-6(a)(1) indicates that the employer may take the deduction in the year the employee recognizes the income. See also Reg. 1.83-1(e) , which provides rules to deal with the situation where the employee forfeits property after including it in income.

8

Billman, 384 T.M., Restricted Property-Section 83, at A-16.

9

See TAMs 8403004, 8403005. In Ltr. Rul. 9102037 , for instance, the Service stated that Reg. 1.83-6(a)(3) "provides an exception to the general timing rule for the deduction. In cases where the property transferred is substantially vested upon transfer, the deduction is allowed to the service recipient in accordance with the recipient's normal method of accounting."

10

See the discussion in the Preamble to the final Section 461(h) Regulations regarding the interrelationship of Section 83 , particularly Section 83(b) , with Section 461(h) . TD 8408 , 4/9/92.

11

Conference Report, supra Note 4 , at 584.

12

Id. at 587.

13

Id.

14

See McDonald, 764 F. 2d 322 , 56 AFTR 2d 85-5318 , and Gresham, 752 F. 2d 518 , 55 AFTR 2d 85-667 .

15

Section 422(c)(7) (originally Section 422A(c)(10) when added by DRA '84) provides that for purposes of Section 422 (dealing with ISOs), the FMV of stock is determined without regard to any restriction other than a restriction which, by its terms, will never lapse.

16

Junior stock is common stock with fewer rights than regular common and which automatically converts to regular common on the occurrence of specified contingencies, such as the company's earnings reaching a designated level. Career shares are formula-priced book value common shares convertible into regular shares at a ratio specified when issued or resellable to the employer at the formula price (book value).

17

Under the FASB proposal, the financial accounting treatment of fixed and variable priced options will, in a broad sense, be equalized. See Exposure Draft, Accounting For Stock-Based Compensation, Financial Accounting Standards Board (6/30/93).

18

Conference Report, supra Note 4 , at 587.

19

The definition of "outside director" is more restrictive than both the proxy statement requirements regarding interlocking directorship disclosure and the rules regarding disinterested status in connection with the SEC Rule 16b-3 exemption. It is clear, for instance, that a disinterested director under Rule 16b-3 might not be an "outside director" under Section 162(m) .

20

Conference Report, supra Note 4 , at 587.

21

id. at 588.

22

Id.

23

17 CFR Section 228.402 (SEC regulation S-K), Item 402(c) (1992); and Executive Summary of Regulation S-K, 57 Fed. Reg. 48126, 48135 (10/21/92).

24

17 CFR Section 228.402 (SEC Regulation S-K). Instructions (3) and (5) to Item 402(c) (1992); and Executive Summary of Regulation S-K, supra.

25

17 CFR Section 228.402 (SEC Regulation S-K). Instruction (4) to Item 402(c) (1992).

26

Conference Report, supra Note 4 , at 588.

27

Id. at 586.

28

Id. at 588.

29

Section 162(m)(4)(C)(ii) ; Conference Report, supra Note 4 , at 58.

30

Section 83(e) ; Reg. 1.83-7(a) (an option "without readily ascertainable market value" at grant is taxable to the optionee at exercise); Section 83(h) (deduction permitted to grantor of option in the tax year during which ends the tax year in which the optionee is taxed).

31

17 CFR Section 228.402 (SEC Regulation S-K), Instruction 7(b)(1) to Item 402(a)(2).

32
Section 425 was redesignated Section 424 by RRA '90. Section 11801(c)(9)(A)(i) . This article generally refers to Section 424 , regardless of the year, unless in context such reference would be confusing.

33
Rev. Rul. 73-326, 1973-2 CB 149 .

34
Prop. Reg. 1.425-1(e)(5)(i) .

35
Ltr. Rul. 8627030 .

36
Ltr. Rul. 8132128 (but creation of a loan program to Refinance loans obtained by employees from financial institutions used to exercise the option is not a modification under Section 425(h)(3) (now Section 424(h)(3)).

37
Prop. Reg. 1.425-1(e) (1984) .

38
Id.

39
Rev. Rul. 74-546, 1974-2 CB 142 (amendment eliminating prohibition against the transfer, sale, pledge or disposition within three years of stock acquired under the option is a modification). But see Rev. Rul. 68-213, 1968-2 CB 229 (removing restrictions on stock after exercise is not a modification, as long as there is no agreement to do so before exercise).

40
Reg. 1.425-1(e)(5)(ii)(b) .

41

Rev. Rul. 71-40, 1971-1 CB 135 .

_____

42

Ltr. Rul. 8132128 ; Morris, 70 TC 959 .

_____

43

Rev. Rul. 71-166, 1971-1 CB 135 .

_____

44

Ltr. Rul. 8903079 .

_____

45

Regs. 1.425-1(a) and (e). See also Rev. Rul. 67-434, 1967-2 CB 170 . For example, Rev. Rul. 71-385, 1971-2 CB 215 , holds that a change in the price of outstanding stock options to reflect decline in the value of the stock resulting from a spin-off reflects a Section 424(a) transaction and is not a modification. See also Ltr. Ruls. 8830035 (stock substitution pursuant to an A reorganization is not a modification); 8841022 (assumption of target company's incentive stock options by parent is not a modification); 8930004 and 8839046 (substitution of parent's incentive stock options for those of sub after a merger is not a modification).

_____

46

See, e.g., H. Rep't No. 749, 88th Cong., 1st Sess., Appendix ("Technical Explanation of the Bill") at A80 (1963).

_____

47

See Executive Summary of Regulation S-K, supra Note 23 .

_____

48

17 CFR Section 228.402 (SEC Regulation S-K). Instruction 3 to Item 402(b)(2)(iv).

_____

49

S. Rep't No. 830, 88th Cong., 2d Sess. 93-94 (1964).

_____

50

See, e.g., Ltr. Rul. 8904011 (amendment of options to make them exercisable immediately on termination of

employment is not a modification); Rev. Rul. 70-94, 1970-1 CB 112 (amendment to permit immediate exercise by employee's estate after his death is an acceleration of exercise period, not a modification under Section 425(h)(3) ; Rev. Rul. 74-504, 1974-2 CB 141 (amendment to provide that option is exercisable in full 30 days after the termination of employment, rather than in installments, is an acceleration of the exercise period, not a modification under Section 425(h)(3)).

51

Reg. 1.421-4(c) (TD 6275 , 12/9/57).

52

Conference Report, supra Note 4 , at 587.

53

Ltr. Rul. 8537010 . See also Ltr. Rul. 8645024 and Rev. Rul. 71-40 , supra Note 36 (where option plan provided that option price could be paid for in installments at the discretion of the compensation committee, committee's exercise of its discretion is not modification). See also Rev. Rul. 74-144, 1974-1 CB 105 (reduction of the number of shares subject to option to comply with plan established pursuant to Economic Stabilization Act of 1970 is not a reduction if it is proportionate, since terms of the option plan gave the compensation committee discretion to reduce the number of shares in this way).

54

Conference Report, supra Note 4 , at 586.

55

Id.

56

Id. at 587.

57

Id. at 586, fn. 46.

58

Rev. Rul. 59-68, 1959-1 CB 95 .

59

Ltr. Rul. 8642048 (A plan provided for payroll deductions to pay option exercise price on termination of employment; the employer interpreted the plan to permit extra cash payments by an employee whose payroll deductions were insufficient to cover the exercise price, and IRS held that the employer's action was a modification of the option.)

60

Conference Report, supra Note 4 , at 587.

61

Id. at 588.

62

Repealed by RRA '90.

63

S. Rep't No. 830, supra Note 49 .

64

Rev. Ruls. 73-26, 1973-1973-1 CB 204 , and 74-606, 1974-1974-2 CB 141 .

65

Id. See also Rev. Ruls. 71-81, 1971-1971-1 CB 134 , and 69-428, 1969-1969-2 CB 103 .

66

SEC Regulation S-K, Instruction 3 to Item 402(b)(2)(i).

67

Like tandem options, cancellation and replacement of options are required by the SEC to be disclosed to shareholders as new options issued at the new option price. 17 CFR Section 228.402 (SEC Regulation S-K), Instruction 3 to Item 402(b)(2)(i).

68

58 Fed. Reg. 42882 (8/12/93).

69

Conference Report, supra Note 4 , at 588 (example of binding contract specifies that "amounts payable under the plan are not subject to discretion").

70

Id. at 589.

71

Id.