

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