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 cancelation, 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 to the shareholder disclosure rules in § 1.162–27(e)(4)(i). However, the shareholder disclosure amendment was not