

Internal Revenue Service

Department of the Treasury
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Date:

October 12, 2004

Taxpayer =

Executive =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

Stock Option Plan A =

Stock Option Plan B =

m =

Date X =

This is in response to a letter of May 24, 2004, submitted by your authorized representative, requesting a ruling under section 162(m) of the Internal Revenue Code.

Specifically, you have requested a ruling that, under the facts described below, the compensation payable to Executive upon the exercise of certain options will constitute qualified performance-based compensation for purposes of section 162(m). The facts, as represented, are as follows.

Taxpayer is a publicly held corporation within the meaning of section 162(m)(2). The compensation committee of the Taxpayer's board of directors ("Compensation Committee") has granted nonstatutory stock options ("Options") to Executive in Year 1, Year 2, Year 3, Year 4 and Year 5. It has been represented that the Compensation Committee was comprised solely of two or more outside directors, as defined in section 1.162-27(e)(3) of the Income Tax Regulations. Executive is a covered employee within the meaning of section 162(m)(3).

The options were issued under Stock Option Plan A and Stock Option Plan B, each of which was approved by the Taxpayer's shareholders. Both Plans specify a maximum aggregate limit on the number of options that can be granted under the Plan. Neither Plan contains a limit on the number of options that can be granted to any individual, other than the aggregate Plan limit. Both Plans provide that no option would be exercisable to the extent the resulting compensation would not be deductible under section 162(m).

Each option grant was the subject of a separate option grant agreement specifying the number of options granted, the exercise price of each option and the term of the option. The exercise price of each option is set at the fair market value of the Taxpayer's stock on the date the respective option was granted. The term of each option grant was m years.

It has been represented that each option grant agreement prohibits any option from being exercised to the extent it results in compensation to Executive in any tax year that is not deductible under section 162(m). Options that are not exercisable as a result of this restriction remain subject to the expiration under the terms of the option grant agreement and thus, may never become exercisable. None of the above described options have been exercised and no payment of compensation with respect thereto has been made. Nor have any of the above described options been re-priced, modified, or amended in any way. It has been represented that the option term will not be extended. In addition, the Taxpayer will not convert the options into deferred compensation, through deferral of exercise proceeds or otherwise, or into current compensation, other than through exercise.

At the Taxpayer's annual shareholder meeting on Date X, the Taxpayer's shareholders will vote on a proposal to approve as performance-based compensation the payment of compensation upon exercise of the options to the extent such payment would result in compensation to Executive in the tax year in excess of \$1,000,000 (the "proposal"). The proposal includes the number of options granted to Executive under each option grant, the exercise price of each option and confirmation that the exercise

price was equal to the fair market value of the Taxpayer's stock on the date each grant was made. If the shareholders do not approve the proposal, the options remain unexercisable to the extent that the resulting compensation would be nondeductible under section 162(m).

Section 162(a)(1) allows as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered.

Section 162(m)(1) provides that in the case of any publicly held corporation, no deduction is allowed for applicable employee remuneration with respect to any covered employee to the extent that the amount of the remuneration for the taxable year exceeds \$1,000,000.

Section 162(m)(4)(C) provides that applicable employee remuneration does not include any remuneration payable solely on account of the attainment of one or more performance goals, but only if (i) the performance goals are determined by a compensation committee of the board of directors of the taxpayer which is comprised solely of 2 or more outside directors; (ii) the material terms under which the remuneration is to be paid, including the performance goals, are disclosed to the shareholders and approved by a majority of the vote in a separate shareholder vote before the payment of such remuneration, and (iii) before any payment of such remuneration, the compensation committee referred to in clause (i) certifies that the performance goals and any other material terms were in fact certified.

Under section 1.162-27(e)(2)(vi)(A) of the regulations, compensation attributable to a stock option is deemed to satisfy the performance goal requirement of section 1.162-27(e)(2) if the grant is made by the compensation committee; the plan under which the option is granted states the maximum number of shares with respect to which options may be granted during a specified period to any employee; and, under the terms of the option, 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.

Section 1.162-27(e)(4)(i) provides, in part, that 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.

Section 1.162-27(e)(4)(iv) provides that 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.

The facts submitted indicate that any compensation received upon exercise of the options will be based solely on the increase in value of the stock after the date of grant. The number of shares of stock for which options were granted to Executive was specifically stated and disclosed to the shareholders. The options are not exercisable if they would result in compensation which is not deductible under section 162(m), absent shareholder approval.

Based on the facts submitted and provided that shareholders approve the proposal, we rule that the compensation attributable to the exercise of the options by Executive will be considered qualified performance-based compensation within the meaning of section 162(m).

Except as specifically ruled above, no opinion is expressed as to the federal tax consequences of the transaction described above under any other provision of the Code.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely yours,

ROBERT B. MISNER
Senior Technician Reviewer
Executive Compensation Branch
Office of the Division Counsel/Associate Chief
Counsel (Tax Exempt and Government
Entities)

Enclosure:

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