INTERNAL REVENUE SERVICE
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July 20, 1999

Company =

year a =

year b =

year c =

date d =

Dear

This is in reply to a request for rulings concerning the deduction limitation of section 162(m) of the Internal Revenue Code. The facts, as presented by Company, are as follows.

Company is a publicly-traded corporation. Company has had a nonqualified stock option plan since year a. The plan has included a reload feature since year b. A new year c plan has been adopted by Company's board of directors and was submitted for shareholder approval at its date d annual meeting. Under both the year b plan and the new year c plan, participants are entitled to exercise their options by paying the option purchase price in cash (including through a "cashless exercise" using the services of a broker) or in already-owned shares of Company stock. Under the cashless exercise method of paying the cash purchase price of the option, the employee arranges through a broker to sell, simultaneously with the option exercise, enough shares of the option stock to cover the option exercise price and related tax withholdings. After settlement, sufficient proceeds from the sale are delivered by the broker to Company to pay the option exercise price and tax withholdings.

Company has offered reload options in connection with exercises of options under its year b plan. Reload options will also be offered under the new year c plan. Company describes a reload option as a new stock option that is granted to an employee on exercise of a nonqualified stock option. The reload option is granted for

the number of shares that are sold or surrendered to pay the option exercise price on the original option, plus the federal, state, and local tax withholdings with respect to the option income. The option exercise price on the reload option is equal to the fair market value of the shares on the date of grant of the reload option (i.e., at the date of exercise of the original option, which triggers the reload option grant).

Company has historically valued the stock transferred upon option exercise based on the mean between the high and low price for the stock on the date of the option exercise. Company now proposes to begin valuing the stock received in the case of a cashless exercise (and setting the option exercise price for reload options received in the case of a cashless exercise of the original option) based on the actual sales price realized by the employee. Taxpayer proposes to use this new valuation method in connection with both (i) prior option grants, including reload option grants, under the year b plan that have not yet been exercised, and (ii) future option grants, including reload grants, under the new year c plan.

Section 162(a)(1) of the Code 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) of the Code 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) of the Code defines "applicable employee remuneration", with respect to any covered employee for any taxable year, generally as the aggregate amount allowable as a deduction for the taxable year (determined without regard to section 162(m)) for remuneration for services performed by the employee (whether or not during the taxable year). However, pursuant to section 162(m)(4), the term does not include 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 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 shareholders and approved by a majority of the vote before the payment of the 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 satisfied.

Section 1.162-27(e)(2) of the Income Tax Regulations provides, in part, that 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. 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. 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.

Compensation attributable to a stock option is deemed to satisfy the requirements of paragraph (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.

Based on the facts submitted, we rule that:

1. Company's use of two different pricing methods for setting the exercise price on reload options, depending on whether or not the reload options were acquired through a cashless exercise, will not violate the requirement in section 1.162-27(e)(2)(vi) that options must be granted at an option exercise price equal to or greater then the fair market value of the stock on the date of the option grant.

2. Company's use of the new pricing method in connection with all future cashless exercises of options does not violate the requirement that the compensation from a stock option be based solely on an increase in the value of the stock after the date of the grant.

The above rulings are based on the condition that the arrangement to sell the stock occurs simultaneous with the exercise of the options and that the arrangement to sell is at the market price. Also, these rulings are based on the condition that the exercise price is set at the gross sales price of the stock tendered in a cashless exercise.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent. Except as specifically ruled above, no opinion is expressed as to the federal tax consequences of the transaction described above under any other provisions of the Code.

Sincerely yours,

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ROBERT B. MISNER
Assistant Chief, Branch 4
Office of the Associate
Chief Counsel
(Employee Benefits and
Exempt Organizations)

Enclosure:
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