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Section 162(m): Immediate Action May Be Required to Preserve Performance-Based Compensation Deduction

The deadline for public companies to amend their performance-based compensation arrangements to comply with a new rule under Internal Revenue Code Section 162(m) is December 31, 2009. This client alert summarizes the action your company may need to take before year end to comply with the new rule.

Section 162(m) Generally. Section 162(m) generally prohibits public companies from deducting compensation in excess of \$1 million paid to its chief executive officer and three other highest paid officers (other than the principal financial officer) in a particular tax year. The CEO and three other highest paid officers are referred to as “covered employees.”

Performance-Based Compensation Exception. There are certain exceptions to the limits under Section 162(m), including an exception for “performance-based compensation.” To qualify for the performance-based compensation exception, the following requirements must be met:

- the compensation must be paid solely on account of the attainment of one or more pre-established, objective performance goals;
- the performance goals must be set generally no later than 90 days after the beginning of the performance cycle;
- the performance goals must be approved by a compensation committee comprised solely of two or more outside directors;
- the compensation committee must not retain the right to increase an award (although it may retain the right to reduce an award);
- the “material terms” of the performance plan (including the eligibility requirements, bonus criteria, maximum amount payable or formula used to calculate the award) must be approved by the shareholders (and must be reapproved at least every five years); and
- the compensation committee must certify in writing that the performance goals have been met before any payments may be made.

In addition, special rules (including a lower \$500,000 annual deduction limit) apply to recipients of Troubled Asset Relief Program funds.

New Restriction on Use of Performance-Based Compensation Exception. Last year, the IRS issued [Revenue Ruling 2008-13](#) which held that compensation arrangements will not qualify for the performance-based compensation exception under Section 162(m) if the terms of the compensation arrangement permit payment to a covered employee whose employment is terminated by the company without cause or by the covered employee due to good reason or retirement, even if the covered

employee continues to work for the company and receives a bonus upon attainment of the performance goals. For more information about Revenue Ruling 2008-13, see our [previous client alert](#).

The ruling does not affect performance-based compensation paid on account of death, disability or change of ownership or control. Compensation arrangements that provide for the payment of performance-based compensation on account of death, disability or change of ownership or control may continue to qualify as performance-based compensation for purposes of Section 162(m). However, any payments made on account of such an event, without regard to whether the performance goals are actually achieved, will be subject to the \$1 million limit under Section 162(m).

Transitional Relief for Performance-Based Compensation Generally Expires December 31, 2009.

Soon after Revenue Ruling 2008-13 was issued, [the IRS announced transitional relief](#) which grandfathered (1) employment agreements in effect on February 21, 2008, without regard to future renewals or extensions, and (2) arrangements for which the performance period began on or before January 1, 2009. Many public companies provide incentive pay on a calendar year basis. Plans of these public companies that are intended to meet the performance-based compensation exception under Section 162(m) (that are not otherwise grandfathered) must be amended by the end of 2009 to comply with the new rule under Section 162(m).

Performance Arrangements Subject to New Rule. Arrangements that may be affected by the new rule include:

- annual bonus plans;
- long-term incentive plans;
- performance-based cash, restricted stock and restricted stock unit awards; and
- employment, change of control and similar agreements.

The IRS has informally noted that employment agreements that provide an amount of severance tied to a portion or all of the covered employee's annual target bonus may be affected by the new rule, as such amounts could be viewed as a substitution of amounts that would otherwise have been paid under the performance-based plan.

Performance Arrangements Generally Not Subject to New Rule. Arrangements that generally should not be affected by the new rule include:

- Non-discounted stock option and stock appreciation rights awards (which are deemed to meet the performance based compensation exception if certain other requirements are met);
- Performance-based awards that are payable only upon termination of employment by the company without cause or by the covered employee due to good reason or retirement only to the extent that performance goals are met;
- Performance-based awards that are payable regardless of attainment of the performance goals in the event of death, disability or a change of ownership or control (note, however, that amounts actually paid on account of one of these events will be subject to the \$1 million limit under Section 162(m)); and

- Compensation payable to employees other than covered employees.

Required Action. If your company is a public company, it is important to review all of your company's performance arrangements that may be affected by the new rule to ensure that they comply with Section 162(m). To comply with the new rule, the following actions may be considered:

- Performance-based arrangements that provide for the payment of performance awards or vesting of performance-based equity upon termination of employment by the company without cause or by the covered employee due to good reason or retirement may be amended to provide that such payments will be made only if and to the extent that performance goals are actually achieved;
- Employment agreements that provide for severance pay based upon performance-based compensation (such as an amount equal to a pro rata share or multiple of the covered employee's target bonus) may be revised to provide that such payments will only be made if and to the extent that performance goals are actually achieved or to restructure the severance payment so that it is not viewed as a substitute for the current bonus (such as paying severance in an amount equal to an average of prior years' bonuses); and
- Employment agreements that provide for vesting of performance-related awards upon termination of employment by the company without cause or by the covered employee due to good reason or retirement may be modified to require that such vesting will only be made to the extent that performance goals are actually achieved.

Such amendments may require the consent of the covered employee or approval of the compensation committee and/or board of directors. It is also important to consult with the company's financial advisors and accountants to determine the financial and accounting impact of such amendments.

In addition to reviewing your company's current performance-based compensation arrangements and employment agreements, the new rule should be considered when designing new performance-based compensation arrangements.

Our client alerts are for general informational purposes and should not be regarded as legal advice. If you would like additional information or have any questions, please contact:

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