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Gauging Impact of IRS Rule on Performance-Based Compensation

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In two major announcements earlier this year, the IRS reversed its long-standing position on the tax deductibility of performance-based compensation under §162(m) of the Internal Revenue Code if the compensation is payable to an executive whose employment is terminated without "cause" or if the executive terminates for "good reason" or retires.

BACKGROUND

Section 162(m) of the Code, generally, precludes a public company from taking a tax deduction for compensation in excess of \$1 million paid to its CEO or its other most highly compensated executives (other than its CFO) reported in its proxy statement.

An exception applies, however, to "performance-based" compensation that meets certain criteria. The Treasury regulations interpreting §162(m) state that an award is not performance-based if it could be paid if the performance goals are not achieved. Thus, a company can't have an alternative plan that pays the award if the performance goals are not achieved.

The regulations do permit, however, compensation to remain performance-based even though the compensation is payable upon the executive's death or disability or upon a change in control. If payment of the award is actually made upon the occurrence of one of these events even though the performance goals are not achieved, the payment will not be performance-based, but the possibility of those payments does not preclude the tax deductibility of the payment if it is actually made upon satisfaction of the performance goals.

The performance-based exception is pretty important, as most public companies use it to some extent.

PRIOR RULINGS

In 1999 and 2006, the IRS issued private letter rulings extending the favorable tax treatment of payments on death, disability and change in control to payments upon termination without "cause" or for "good reason." Termination for good reason is a termination by the executive claiming constructive termination for reasons such as reduction in compensation, title or authority or relocation of office. Although private letter rulings may be relied upon only by the taxpayer to whom they are issued, tax practitioners, generally, assume that they set forth the IRS position on a subject and, therefore, constitute "substantial authority" for purposes of avoiding penalties.

2008 PLR

The IRS published PLR 200804004 (.pdf) in January, reversing its position in the 1999 and 2006 PLRs. This new ruling held that a provision in an employment contract guaranteeing payment of performance share awards upon the executive's termination of employment without cause or for good reason, without regard to the achievement of the performance goals, made the awards ineligible for the performance-based exception in all circumstances, even if the payment was actually made upon achievement of the performance goals.

The IRS did not express any reason for its reversal, other than noting that the regulations limit the exception to the performance-based rule only to the circumstances of death, disability or change in control.

Because of the implications for financial accounting and reporting, tax and other matters, practitioners pressured the IRS for further guidance, particularly as to whether the new position would be applied



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retroactively or on a prospective basis only. If applied retroactively, the amount of "improperly" taken corporate tax deductions would be significant.

REVENUE RULING 2008-13

The IRS responded in Rev. Rul. 2008-13 (.pdf) by confirming its position in the January 2008 PLR and by extending it to arrangements that guarantee to an executive payment of the performance award upon retirement without regard to the achievement of the performance goals.

The Revenue Ruling stated:

"As defined in the Plan, involuntary termination without 'cause' may occur or a 'good reason' (e.g., a reduction in title or base salary) may arise as a result of covered employee E's poor performance and failure to meet the Performance Goal. Therefore, under the facts and circumstances analyzed, the compensation is not 'remuneration payable solely on account of the attainment of one or more performance goals,' as required by §162(m)(4)(C)."

The Revenue Ruling went on to state:

"Voluntary retirement is not listed as a permissible payment event under §1.162-27(e)(2)(v). Because retirement generally is a voluntary action within the control of the covered employee, the compensation is not 'remuneration payable solely on account of the attainment of one or more performance goals,' as required by §162(m)(4)(C)."

The Revenue Ruling did provide, however, for prospective application and limited transition relief. The IRS position will not apply to compensation payable for performance periods beginning on or before Jan. 1, 2009. This, generally, means that it will not apply until 2010 for calendar year taxpayers. There is even further transition relief for payments made pursuant to employment contracts in effect on Feb. 21, 2008, although such transition relief is not available for compensation paid for subsequent contract extension periods, including automatic rollover periods. Although this relief is helpful, it may not be for as long as it sounds. Many employment contracts have automatic renewal provisions that will limit the transition relief, and the extension of the IRS position to guaranteed payment at retirement will cause problems for many companies.

POINTS TO CONSIDER

Each company will need to analyze its own specific programs, including review of plan documents, grant agreements and employment contracts. Many types of executive compensation are not affected by the new rulings and would not need to be reviewed.

First, compensation for executives and other employees not subject to §162(m) is not affected. For those executives not named in the proxy statement, or unlikely to be named in the proxy statement during the duration of the performance-based grant, a review of their compensation arrangements for this purpose is unnecessary.

Second, compensation that is not intended to comply with §162(m) may be disregarded. This would include elements of compensation such as restricted stock that vests solely upon satisfaction of a period of employment or discretionary bonuses that are not performance-based.

Third, stock options and stock appreciation rights may be eliminated as they qualify as performance-based compensation under special §162(m) rules.

Even after eliminating the foregoing categories, there will be many arrangements to be reviewed for which a company is seeking the §162(m) exemption, including annual and long-term incentive bonus arrangements and performance-based equity compensation plans. Compensation lawyers and HR departments will be scrambling during 2008 to "negotiate" required changes with executives.

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