CORPORATE CLIENT ALERT
IRS Guidance Narrows Performance-Based Compensation Exemption From Deduction Limitation

February 2008

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Section 162(m) of the Internal Revenue Code, which prohibits a publicly held company from deducting more than US$1 million in annual compensation to its CEO and three highest-compensated officers (other than CEO and CFO), exempts performance-based compensation from such deduction limitation. Under Section 162(m), performance-based compensation must be payable solely upon the attainment of preestablished, objective performance goals that are (1) determined by the compensation committee of the company's board of directors composed only of two or more outside directors and (2) approved by shareholders. In addition, the compensation committee must certify that the performance goals were met prior to any payment of performance-based compensation. Compensation will not fail to be "performance-based" merely because the plan provides for the compensation to be paid in the event of death, disability or change in control, except in the year such event occurs.

In a recent reversal from guidance given in two prior private letter rulings, the IRS last month released a private letter ruling holding that all compensation payable under a performance-based incentive plan would not be treated as performance-based compensation exempt from the Section 162(m) US$1 million deduction limitation because the executive also had an employment agreement that provided for the payment of his performance-based incentive compensation in the event of termination for good reason or without cause.
Although private letter rulings apply only to the recipient, they are generally viewed as an expression of the current thinking and position of the IRS. In conversations with the IRS, we have confirmed that the recent private letter ruling is an intentional 180-degree change of course that was studied fully. The IRS indicated that the only events that qualify as exceptions to the attainment of performance goals under a performance-based plan are death, disability or change in control. In the view of the IRS, termination of the executive, whether for good reason or without cause, is not an event that qualifies as an additional exception. Therefore, this shift in position is meaningful and should be taken as a warning to all publicly held corporations.

Moreover, while this private letter ruling has understandably caused consternation with respect to Section 162(m), it potentially has even wider implications. Because of the similarity in the definitions of performance-based compensation under Section 162(m) and Section 409A of the Internal Revenue Code, both publicly held and privately held companies should consider the implications of this ruling on their performance-based programs covered by Section 409A. Section 409A allows for a special late deferral election period for amounts payable under performance-based plans (six months before the end of the performance period, rather than the last day of the preceding calendar year). However, if the IRS were to apply the same reasoning to Section 409A as is reflected in this letter ruling, an executive with an employment agreement similar to that in the letter ruling who elected deferrals in accordance with performance-based compensation rules could be subjected to the 20-percent Section 409A excise tax.

Therefore, employers would be well advised to immediately review their performance-based compensation arrangements as well as any other related plans, programs and agreements (e.g., severance plans and employment agreements) to determine whether any amendments are needed to bring them into compliance with the position of the IRS set forth in this recent private letter ruling, both to avoid the limitation of Section 162(m) and to prevent the potential application of the Section 409A excise tax. Our executive compensation experts would be happy to provide advice regarding how such plans can be amended to comply with this new IRS position and still provide benefits under performance-based plans to executives in the event of their termination for good reason or without cause.

The contents of this alert are not intended to serve as legal advice related to individual situations or as legal opinions concerning such situations. Counsel should be consulted for legal planning and advice.

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February 2008