

New IRS Ruling Holds Performance-Based Exception to 162(m) Lost if Incentive Program Guarantees Payment Upon Termination of Employment or Retirement

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On February 21, 2008 the Internal Revenue Service (IRS) issued Revenue Ruling 2008-13, which materially limits the performance-based compensation exception to the \$1 million deduction limit under section 162(m) of the Internal Revenue Code (Section 162(m)).

Section 162(m) generally limits a public company's tax deduction for compensation paid to the chief executive officer and its other four most highly paid officers to \$1 million per year. This deduction limitation does not apply to qualified performance-based compensation. One of the requirements of qualified performance-based compensation is that the compensation must be paid solely on the attainment of one or more pre-established, objective performance goals.

Revenue Ruling 2008-13 was issued in response to taxpayer concerns and confusion expressed with respect to IRS Private Letter Ruling 200804004, in which the IRS concluded that a performance award plan that guaranteed payment of an award in the event of a participant's termination of employment without cause, or resignation by the participant for good reason, caused the plan to fail to qualify as performance-based compensation under Section 162(m). IRS Private Letter Ruling 200804004 reached a different conclusion from earlier private letter rulings (199949014 and 200613012) in which the IRS had determined that similar provisions did not cause a plan to fail to provide performance-based compensation for purposes of Section 162(m).

The practical impact of Private Letter Ruling 200804004 was to call into question the deductibility of significant amounts of compensation under plans that were designed based on the positions taken by the IRS in earlier private letter rulings. Due to the potentially retroactive application of the contrary position expressed in the more recent private letter ruling, an immediate issue arose as to the appropriate financial accounting treatment for the deductibility of outstanding awards under compensation plans and arrangements affected by the private letter ruling.

Revenue Ruling 2008-13 expands the position expressed in Private Letter Ruling 200804004 to exclude from the performance-based compensation exception not only incentive compensation programs that provide for accelerated payment of compensation upon termination of employment without cause and for good reason, but also programs that provide for such payment upon retirement. Additionally, no payments under such arrangement will qualify for the performance-based exception even if paid after the performance targets are met.

The Revenue Ruling also attempts to address financial reporting and transition concerns through a prospective application provision, such that the revenue ruling does not apply if (1) the performance period for the compensation begins on or before January 1, 2009 or (2) the compensation is paid pursuant to the terms of an employment agreement in effect (without respect to future renewals or extensions, including renewals or extensions that occur automatically) on February 21, 2008. Notably, the revenue ruling further expressly states that “[t]he IRS and Treasury have not previously issued any guidance on which taxpayers are entitled to rely that explicitly addresses the situations described in this revenue ruling.” While it would certainly be desirable for these provisions of the revenue ruling to have the effect of limiting the financial reporting concerns to future periods (by neutralizing the earlier private letter rulings), it remains to be seen whether they will have that effect, given that the conflicting private letter rulings are still outstanding.

From a substantive standpoint, Revenue Ruling 2008-13 provides that an incentive program providing for guaranteed payments upon a termination without cause, resignation for good reason, or retirement causes the awards to fail to satisfy the performance-based exception to Section 162(m) since such terms do not meet the exception that allows compensation to be accelerated upon death, disability, or a change in control. The IRS reasoned that the compensation is not paid solely on the attainment of performance goals since a termination without cause or resignation for good reason may occur as a result of a participant’s poor performance and failure to meet the performance goals and a retirement is generally in the control of the participant. The key point here is that if, under a facts-and-circumstances analysis, the participant’s incentive payment may be paid even if the performance-based conditions are not met (e.g., in a situation where the individual’s employment is terminated without cause), then the affected participant’s award cannot meet the Section 162(m) exception requirements, whether or not the noncompliant payment condition is actually triggered or the performance goals are in fact attained.

Although most incentive compensation plans sponsored by public companies are designed to comply with the performance-based exception to Section 162(m), it is common for such plans (or separate employment or severance agreements) to provide for a minimum payment of performance-based compensation (e.g., at target) upon termination of employment by the company without cause, retirement, or resignation by the participant for good reason. Public companies therefore should review existing plan documents intended to comply with the performance-based exception to Section 162(m) and employment and severance agreements relating to such plans, and work to revise them accordingly. In particular, while the prospective relief provisions described above are helpful, at best they delay but do not eliminate the problem. As a result, all companies with incentive plans that are intended to comply with the Section 162(m) exception must closely review those plans (and any attendant severance arrangements or employment agreements).

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