



Morgan Lewis Webcast: IRS Ruling Threatens Compensation Deductions for Public Companies

Life After Revenue Ruling 2008-13:
Where Do We Go From Here?

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Background

- Section 162(m) limits compensation deductions for “covered employees” at public companies
- Pursuant to IRS Notice 2007-49, this currently means the principal executive officer and up to three other officers reported under the Securities Exchange Act of 1934 by reason of being among the three most highly compensated officers of the company

Qualified Performance-Based Compensation Exception

- The section 162(m) annual deduction limit does not apply to qualified performance-based compensation, which, among other requirements, is conditioned on the attainment of prespecified, objective performance goals
- Discretion to pay if goals are not attained is not generally permitted

Qualified Performance-Based Compensation Exception

- Applicable Treasury Regulations provide that compensation does not qualify as performance-based for this purpose if the facts and circumstances indicate the employee would receive the compensation without regard to attainment of the goal(s)
- Explicit exceptions are provided for death, disability, and change in control

Prior Law

- While binding guidance was not issued on the subject, in PLRs 199949014 and 200613012, the IRS ruled that payment of otherwise performance-based compensation upon “good reason” or involuntary termination did not cause the compensation to fail to be performance-based for purposes of the section 162(m) exception
- PLR 200613012 extended this treatment further to cover an early retirement provision

PLR 200804004

- In this ruling, the IRS reversed course and ruled that a provision that triggered payment of otherwise performance-based compensation upon good reason or involuntary termination caused compensation payable under the plan to be subject to the section 162(m) limit (i.e., it fell outside the exclusion)
- This ruling, in light of the context of recent accounting and tax preparer standard changes, caused consternation as the deductibility of compensation was called into question on a widespread basis

FIN 48 – Accounting for Uncertainty in Income Taxes

- Companies can only recognize tax benefits for amounts meeting the MLTN standard
- Although generally effective beginning in 2007, FIN 48 is applicable for all open tax years, potentially requiring derecognition of previously recognized tax benefits and establishment of a FIN 48 liability for those amounts
- The emerging consensus of auditors and tax advisors after the issuance of PLR 200804004 was that the MLTN standard could not be reached for performance plans with a “safety net” for terminations without cause/good reason
- This resulted in substantial likelihood that Q1 2008 financials for many companies would need to reflect significant reversals of previously recognized tax benefits

Circular 230 and Code Section 6694(a)

- Amendments to tax return preparer rules, generally applicable beginning in 2008, impose penalties on return preparers and certain tax advisors as to positions taken on a return in the absence of a reasonable belief that the position would satisfy the MLTN standard (or, if disclosed on the return, that the position had a reasonable basis)
- PLR 200804004 placed tax preparers in a quandary in planning to prepare 2007 returns for taxpayers who had relied on the earlier PLRs in designing their performance-based plans

Revenue Ruling 2008-13

- In order to implement a more orderly transition from what taxpayers had believed the rule to be to what the IRS decided the rule should be going forward, the IRS issued Revenue Ruling 2008-13
- The ruling basically reaffirms the IRS position that if compensation will be paid upon good reason or involuntary termination, or due to early retirement, without regard to the attainment of the performance goals, the arrangement falls outside the qualified performance-based compensation exception

Prospective Application

- The holdings of Revenue Ruling 2008-13 will not be applied to disallow a deduction for compensation that is otherwise performance-based (under the regulations) for:
 - Performance periods beginning on or before January 1, 2009, or
 - Compensation paid under employment contracts as in effect on February 21, 2008 (without regard to renewals or extensions, or automatic extensions)

Arrangements Impacted

- Performance-based compensation programs
- Employment and severance agreements
- Severance plans that affect covered employees
- Many documents will have to be restructured and revised

Many Unanswered Questions

- Payments on involuntary or good-reason termination that are contingent upon actual attainment of performance goals
- Fractional or pro rata payments based on actual performance
- Involuntary termination following a change in control

Alternative Structures

- Increased salary multiples
- Trailing year's bonus
- Trailing average bonus
- Trailing highest of three
- Substitution implications unclear

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