Executive Compensation
& Benefits

February 24, 2010

2010 Proxies: Action May Be Required to Preserve Executive Compensation Deductions

by Mark C. Jones

During the current proxy season, compensation committees of public companies will want to take into account the new position of the IRS regarding the deductibility of performance bonuses paid upon retirement or termination of employment. Committees should review their incentive pay plans to determine whether these plans need to be restructured to preserve the deductibility of performance-based bonuses before being put before shareholders.

Section 162(m) of the Internal Revenue Code generally limits a public company's federal income tax deduction to $1 million for compensation paid to its chief executive officer and its three other top-paid officers (other than the chief financial officer). An exception from the $1 million limit applies for compensation that is payable "solely on account of" attainment of one or more performance goals. The performance goals must be determined by its compensation committee, comprised of two or more outside directors. Additionally, the material terms of the plan, including the performance goals, must be disclosed to and approved by a majority of the company's shareholders, and the compensation committee must certify that the performance goals and any other materials conditions were in fact satisfied.

IRS regulations allow performance awards to be payable in the event of the participant's death or disability or a change of control, even if the performance goal was not attained, without jeopardizing the award's exemption from the $1 million deductibility limit. In private rulings issued in 1999 and 2006, the IRS applied the same logic to awards that were paid out upon termination of employment. However, the IRS reversed this position in Revenue Ruling 2008-13, reasoning that awards that are payable upon a participant's termination of employment, voluntary resignation or retirement are not payable "solely on account of" performance, and, therefore, are not exempt from the $1 million limit. Revenue Ruling 2008-13 does not apply to awards paid under a performance period beginning on or before January 1, 2009 or under an employment contract in effect on February 21, 2008. But awards to be paid under a performance period commencing after January 1, 2009 or under a newly adopted or revised plan or agreement that will be subject to the new rules. These arrangements, therefore, should be reviewed by the compensation committee to determine whether the awards will still be exempt from Section 162(m) under the IRS's new interpretive standards.

The exception for performance-based awards is not available to companies that have received $300 million or more under the Troubled Assets Relief Program (TARP). In addition, the limit on the deductibility of compensation for the top executives of such companies (including the chief financial officer) is limited to $500,000. These restrictions continue until the company repays the moneys received or for any other reason is no longer subject to TARP.

Public companies should also take this opportunity to review their procedures to ensure that all performance-based awards, including incentive pay, performance-based equity awards, stock options and stock appreciation rights, are approved by an independent compensation committee and that all plans and arrangements providing for these awards, including the performance goals, are put before their shareholders at least every 10 years (every five years if the compensation committee has authority to change the performance measures used to establish the goal). A grace period applies to performance-based plans in existence before a company's initial public offering (IPO) from the date of the IPO through the first shareholder meeting after the end of the third calendar year following the year in which the IPO occurred. Shareholder approval is necessary for any awards made from the plan after the expiration of the grace period. Newly public companies may want to consider seeking this shareholder approval soon after the IPO, when company ownership may be concentrated and shareholder enthusiasm especially high, rather than waiting until the end of the grace period.

If you have any questions about the content of this advisory, please contact the Pillsbury attorney with whom you regularly work or any of the members of the Executive Compensation & Benefits group.

New York

Susan P. Serota (bio)
+1.212.858.1125
susan.serota@pillsburylaw.com

Peter J. Hunt (bio)
+1.212.858.1139
peter.hunt@pillsburylaw.com

Scott E. Landau (bio)
+1.212.858.1598
scott.landau@pillsburylaw.com

John J. Battaglia (bio)
+1.212.858.1738
john.battaglia@pillsburylaw.com

Mark C. Jones (bio)
+1.212.858.1430
mark.jones@pillsburylaw.com

Kathleen D. Bardunias (bio)
+1.212.858.1905
kathleen.bardunias@pillsburylaw.com

Bradley A. Benedict (bio)
+1.212.858.1523
bradley.benedict@pillsburylaw.com

Washington, DC / Northern Virginia

Howard L. Clemons (bio)
+1.703.770.7997
howard.clemons@pillsburylaw.com

Keith R. Kost (bio)
+1.703.770.7799
keith.kost@pillsburylaw.com

San Diego—North County

Jan H. Webster (bio)
+1.858.509.4012
jan.webster@pillsburylaw.com

Kenneth E. Bonus (bio)
+1.858.847.4206
kenneth.bonus@pillsburylaw.com

Daniel N. Riesenberg (bio)
+1.858.847.4130
daniel.riesenberg@pillsburylaw.com

Lori Partrick (bio)
+1.858.509.4087
lori.partrick@pillsburylaw.com

San Francisco

Christine L. Richardson (bio)
+1.415.983.1826
crichardson@pillsburylaw.com

Silicon Valley

Cindy V. Schlaefer (bio)
+1.650.233.4023
cindy.schlaefer@pillsburylaw.com

Grace Chen (bio)
+1.650.233.4873
grace.chen@pillsburylaw.com

This material is not intended to constitute a complete analysis of all tax considerations. Internal Revenue Service regulations generally provide that, for the purpose of avoiding United States federal tax penalties, a taxpayer may rely only on formal written opinions meeting specific regulatory requirements. This material does not meet those requirements. Accordingly, this material was not intended or written to be used, and a taxpayer cannot use it, for the purpose of avoiding United States federal or other tax penalties or of promoting, marketing or recommending to another party any tax-related matters.

This publication is issued periodically to keep Pillsbury Winthrop Shaw Pittman LLP clients and other interested parties informed of current legal developments that may affect or otherwise be of interest to them. The comments contained herein do not constitute legal opinion and should not be regarded as a substitute for legal advice.
© 2010 Pillsbury Winthrop Shaw Pittman LLP. All Rights Reserved.