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IRS 162(m) Ruling Requires Review of Incentive Pay Arrangements

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In Revenue Ruling 2008-13, issued on February 21, 2008, the IRS held that incentive pay cannot qualify as performance-based compensation under Section 162(m) of the Internal Revenue Code if all or a portion can be paid upon the executive's involuntary termination without cause, voluntary termination for good reason or retirement, even if the executive continues in service and the incentive is actually paid upon attainment of the pre-stated performance goal.

The new Revenue Ruling confirms the IRS's holding in Private Letter Ruling 200804004, released on January 25, 2008, which reversed the IRS's long-standing position on this issue. To the relief of many public companies that had structured their incentive plans and awards in reliance on the IRS's prior position, Revenue Ruling 2008-13 will be given prospective application only, as described below.

Background

Section 162(m) imposes a $1 million limit on the allowable deduction for compensation paid to any "covered employee."[1] Amounts that qualify as "performance-based compensation" are not counted towards the $1 million limit. To qualify as performance-based compensation, Section 162(m) requires that the compensation be payable "solely on account of the attainment of one or more performance goals." Treasury regulations under Section 162(m) provide that compensation does not meet this basic requirement if the covered employee could receive all or part of the compensation without attaining the performance goals.

The regulations further provide, however, that compensation does not fail to be qualified performance-based compensation merely because the plan or award permits the compensation to be paid upon the covered

[1] Covered employees include a public company's chief executive officer and its three highest-paid officers other than the CEO, but excluding the chief financial officer.

employee's death or disability, or upon a change of ownership or control of the company, although the compensation actually paid on account of those events prior to the attainment of the performance goal would not be qualified performance-based compensation.

PLR 200804004

On January 25, 2008, the IRS released Private Letter Ruling 200804004, which held that if an employment agreement provides for the automatic payment of performance awards at the "target" level when employment is terminated without cause or for good reason, the performance award does not qualify as "performance-based compensation" under Section 162(m) because it is not payable "solely on account of the attainment of one or more performance goals." According to the ruling, the performance award in question would be subject to the $1 million deduction limit under Section 162(m), even if employment was not terminated and the award was actually paid upon attainment of the pre-stated performance goal.

This ruling reflected a reversal of the IRS's position stated in two prior private letter rulings (PLR 199949014 and PLR 200613012). In the 1999 ruling, the IRS stated that compensation paid under a performance-based stock award plan would not fail to qualify for deduction as performance-based compensation under Section 162(m) even if the plan provided for accelerated stock vesting upon the employee's termination without cause or for good reason. The IRS reasoned that such "involuntary terminations" were substantially similar to terminations due to death, disability or a change of control so as to be included under the exception in the regulations for accelerated payments on account of those events. The 2006 ruling further extended the exception to include incentive payments made early on account of the executive's retirement.

In PLR 200804004, however, the IRS interpreted the "death, disability and change in control" exception in the regulations much more literally, holding that an award that could become payable before attainment of the performance goals due to the occurrence of any event other than death, disability or a change of control does not qualify as performance-based compensation for purposes of Section162(m). IRS private letter rulings are binding only on the companies that requested the rulings. But by creating uncertainty regarding the deductibility of prior and pending incentive pay, the new ruling raised tax and financial accounting concerns among public companies that relied on the earlier IRS rulings.

Revenue Ruling 2008-13

Revenue Ruling 2008-13, unlike PLR 200804004, applies to all public companies. The new Revenue Ruling confirms the IRS's holding in PLR 200804004 that an incentive award that permits payment of all or part of the award upon an executive's involuntary termination without cause or termination for good reason will cause the award to fail to qualify as Section 162(m) performance-based compensation. The IRS reasoned that such an award is not payable "solely upon the attainment of the performance goals," as required by the regulations, because these types of termination may arise as a result of the executive's poor performance and a failure to meet the performance goal. The Revenue Ruling also expanded this holding to incentive awards that are paid early in connection with the executive's retirement. According to the IRS, the incentive award in this case is not payable solely on attainment of the performance goals because "retirement generally is a voluntary action within the control of the covered employee."

Transition Relief; Prospective Application

In view of the fact that, in reliance on the IRS' prior rulings, many existing plans and employment agreements provide for accelerated payments on involuntary terminations or retirement, the IRS has limited the application of Revenue Ruling 2008-13 to future arrangements only. Under this transition relief, the IRS will not apply the holdings in Revenue Ruling 2008-13 to disallow a deduction for any compensation that otherwise satisfies the requirements for performance-based compensation under Section 162(m), except for permitting all or a portion of the compensation to be paid upon the executive's involuntary termination without cause, good reason termination or retirement, if either (i) the performance period begins on or before January 1, 2009 or (ii) the compensation is paid pursuant to an employment agreement as in effect (excluding renewals) on February 21, 2008.

Employment agreements in effect on February 21, 2008 will no longer be covered by this transition relief upon their renewal (including automatic renewals). Thus, public companies should review their executive employment agreements prior to renewal to determine if any modifications are needed to ensure deductibility of incentive pay under Section 162(m). In the longer term, public companies will need to consider the new deductibility limitations when structuring new incentive pay arrangements with performance periods beginning after January 1, 2009.

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