

Legal Updates & News

Legal Updates

IRS Stands By Reversal on Performance-Based Compensation Under Section 162(m), Provides Transition Relief

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The IRS has issued a revenue ruling that confirms a new position taken in a recent private letter ruling with respect to qualified performance-based compensation under Section 162(m). The new revenue ruling confirms that if payments can be made under a plan without regard to performance upon an affected executive's termination of employment for reasons other than death, disability or change of control, then no payments under the plan will qualify as performance-based compensation under Section 162(m). The new position potentially affects not only Section 162(m) cash bonus plans, but also stock-based incentives, such as restricted stock, restricted stock units, and performance shares, whose vesting or payment may be contingent on performance.

Section 162(m)

Section 162(m) generally disallows a tax deduction to a publicly held company for annual compensation in excess of \$1 million that is paid to a "covered employee" (*i.e.* the principal executive officer (typically the CEO) or one of the three highest-paid executive officers other than the principal executive officer or the principal financial officer). Compensation for this purpose generally includes all remuneration for services performed by the covered employee, whether or not the services were performed during the same taxable year.

Performance-Based Compensation

Qualified performance-based compensation, which is payable solely upon attainment of pre-established, objectively determinable performance goals pursuant to a shareholder-approved plan, is excluded from the \$1 million deduction limitation. Many public companies make significant awards under qualified performance-based compensation plans for the benefit of their executives to take advantage of the exclusion of such amounts from consideration under Section 162(m).

Prior IRS Position

Treasury regulations provide that a performance-based plan that permits payments upon death, disability or a change of control (without regard to whether performance goals have been met) will not disqualify payments that are made upon the attainment of performance goals. Earlier private letter rulings had extended similar protection to payments on account of termination without cause or for good reason, or upon retirement. Based on the earlier IRS position, many companies have employment, severance, change of control and other agreements with executives providing that benefits will be paid upon termination without cause, for good reason, or upon retirement, without a requirement of actual performance.

Transition Relief

The revenue ruling has prospective effect only and there is a transition period. The new revenue ruling does not apply to compensation that otherwise qualifies as performance-based compensation

if either (i) the performance period for the compensation begins on or before January 1, 2009, or (ii) the compensation is paid in accordance with an “employment agreement” in effect on February 21, 2008. This means that performance periods that are in progress and existing employment agreements may continue to provide payments under the prior IRS position.

Exactly what constitutes an “employment agreement” is not entirely clear. Many similar arrangements are found in severance or change of control agreements and plans. If the term is construed narrowly, then pre-February 22, 2008 “severance agreements,” for example, would not be afforded transition protection, though that position does not make sense as a matter of policy. In addition, it is unclear what types of amendments to pre-February 22, 2008 employment agreements will terminate the transition with respect to such agreements. The revenue ruling does make it clear that the renewal or extension of a protected agreement, including an automatic renewal or extension, will cause the protection to end.

What Companies Should Do Now

Public companies should inventory their Section 162(m) compensation programs, employment, severance, change of control, and similar plans and agreements to determine whether their provisions are affected by the new ruling. Companies should consider whether to begin grandfathered performance periods before January 1, 2009. They should also determine when existing “employment agreements” will become subject to the new IRS rule. Finally, they should begin preparations to amend their performance-based plans and arrangements effective January 1, 2009. In planning for such amendments, companies should also consider whether executives’ consent or shareholder approval is required.