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LEGAL ALERT



Legal Alert: IRS Adopts Controversial Private Letter Ruling Regarding Deductibility of Certain Severance Payments

2/29/2008

In a recent Revenue Ruling, No. 2008-13, the IRS ruled that a compensation award payable upon the employee's retirement, termination without cause by the employer, or resignation with good reason by the employee, without regard to the achievement of performance goals, is not considered "qualified performance-based compensation" under Section 162(m) of the Internal Revenue Code of 1986 (the "Code"). This Revenue Ruling and a prior private letter ruling on this question reflect a change in the IRS's position.

Code Section 162(m) provides that publicly traded companies generally cannot claim a deduction for compensation paid to the company's chief executive officer and certain other highly paid executives to the extent that such compensation exceeds \$1,000,000 per year. However, the Section provides for an exception: (1) if the compensation is contingent upon attaining one or more pre-established objective performance goals; (2) a compensation committee comprised solely of two or more outside directors establishes the performance goals; (3) the material terms of the compensation, including the required performance goals, are disclosed to shareholders and approved by the vote of a majority of the shareholders prior to payment of the compensation; and (4) the compensation committee certifies that the performance goals and any other material terms are satisfied prior to payment.

The regulations under Code Section 162(m) provide that compensation is not "performance-based" if the facts and circumstances indicate that the employee would receive all or part of the compensation regardless of whether the performance goal is attained. The regulations further provide that compensation does not fail to be qualified performance-based compensation merely because the plan allows the compensation to be payable upon death, disability, or change of ownership or control of the company. However, compensation actually paid on account of death, disability, or change of ownership or control *prior to the attainment of the performance goals* does not qualify as performance-based compensation under the regulations.

Under the fact pattern described in the Revenue Ruling, the employer's plan provides that the compensation be paid in connection with the employee's involuntary termination without cause, resignation for good reason, or voluntary retirement, without regard to whether the employee's performance goals had been attained. On the facts, the IRS ruled that the compensation is

not “payable solely on account of the attainment of one or more performance goals.”

Apparently in response to a letter signed by 90 law firms, the Revenue Ruling will not be applied to disallow a deduction for any compensation that otherwise satisfies the requirements for qualified performance-based compensation under Code Section 162(m) if the performance period for such compensation begins on or before January 1, 2009 or the compensation is paid pursuant to the terms of an employment contract as in effect on February 21, 2008.

Employers’ Bottom Line:

The position taken by the IRS in this Revenue Ruling may require employers to reevaluate compensation provisions applicable to certain employees. However, any revisions to such provisions should be carefully considered in conjunction with experienced benefits or tax counsel, taking into account the impact of other laws, such as the requirements of Code Section 409A.

If you have any questions regarding this Revenue Ruling or other benefits related issues, please contact the Ford & Harrison attorney with whom you usually work, or Stephen Zweig, szweig@fordharrison.com, 212-453-5906 or Victoria Chemerys, vchemerys@fordharrison.com, 305-808-2107, of Ford & Harrison’s Employee Benefits Practice Group.