Payments Do Not Qualify as Performance Based Compensation Under 162(m) Where Payments are Permitted Under a Severance Arrangement

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The Internal Revenue Service published a private letter ruling on January 28, 2008 (PLR 200804004) holding that amounts paid to a recipient under an incentive compensation plan intended to qualify as performance-based compensation under Section 162(m) of the Internal Revenue Code of 1986, as amended, (the "Code") will not qualify as performance-based compensation where the recipient's employment agreement provides for payment of the performance compensation upon a termination of employment without cause or for good reason, whether or not the performance metrics are satisfied.

Code Section 162(m) limits a public company's tax deduction for compensation paid to covered employees to $1 million per covered employee per year. This limitation does not apply to "performance-based" compensation programs. A "covered employee" includes a company's principal executive officer (i.e., its CEO) and its other three highest compensated officers (other than the principal executive officer or the principal financial officer).

In this PLR, the company had entered into an employment agreement with an executive who had received performance shares and units under its performance-based incentive compensation plan. The executive's employment agreement provided that in the event he was terminated without cause or for good reason (as such terms were defined in the agreement), then any performance goals would be deemed to have been satisfied and such performance shares or units would vest at the time of termination to the extent the shares or units would have vested in accordance with the normal vesting schedule had the executive remained employed for two years.

The IRS held that the provision in the employment agreement allowing for payment of performance shares or units upon the executive's termination of employment without cause or for good reason did not meet the exception in the regulations under Section 162(m) that permits compensation to be paid upon death, disability or change in the ownership or control of the company. Accordingly, the IRS held that compensation paid to the executive would not be considered performance-based compensation under Section 162(m) of the Code even where the executives do not terminate employment but instead satisfy the performance metrics.

PLR 200804004 differs from the IRS holding in two earlier private letter rulings which found that amounts paid under an incentive compensation plan upon satisfaction of the relevant performance metrics qualified as incentive compensation notwithstanding the fact that the plan would provide payment upon retirement or upon an involuntary termination without the relevant performance metrics having been met. Under these earlier rulings only the bonuses paid upon retirement or upon an involuntary termination would fail to qualify as performance based compensation.

What Should You Do?

It is unclear whether PLR 200804004 revokes the prior IRS rulings. However, at a minimum, and pending further advice from the IRS, which may take the form of a published ruling in the near future, companies should consider amending employment agreements, or their incentive arrangements (including performance-based stock and RSU grants) to delete provisions that permit payment (or vesting) upon an involuntary termination of employment apart from a change of control. In this regard, it is the performance stock grants that provide the biggest potential tax concerns as it is the value of the awards at the vesting (or in the case of options, exercise) dates where the potential loss of deduction occurs. Further, we understand that auditors have started to consider the need for FIN 48 reserves to be taken for performance based payments made in 2008 that could be affected by the new IRS position. The good news is that it may be possible to achieve the company's intended result of paying out a portion of any bargained for incentive compensation upon termination in the form of an increased multiple of salary. However, you should discuss this possibility with your legal and accounting advisors if you maintain a 162(m) shareholder approved plan and in any event before implementing alternative arrangements as a result of PLR 200804004.

PLR 200804004 may be viewed at:
http://www.irs.gov/pub/irs-wd/0804004.pdf

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