

April 2008

IRS LIMITS SCOPE OF IRC SECTION 162(m) PERFORMANCE-BASED COMPENSATION DEDUCTION

The IRS issued Revenue Ruling 2008-13 to clarify what constitutes “performance-based” compensation under Internal Revenue Code Section 162(m). This ruling puts many executive compensation plans and employment agreements at risk in light of the new restrictions on deductions for non-performance-based compensation that exceeds \$1 million.

Code Section 162(m) provides that publicly held corporations may not deduct compensation in excess of \$1 million paid to covered officers — i.e., the chief executive officer and the three highest paid executive officers other than the chief executive officer and chief financial officer. An exception to this limitation is available, however, for performance-based compensation that meets specified criteria. Revenue Ruling 2008-13 reverses prior IRS rulings on how to satisfy the performance-based exception under Section 162(m). Under these previous rulings, an executive could receive a performance award (either cash or equity) upon involuntary termination without cause, termination for good reason, or retirement, without regard to whether performance goals were actually met. Under the latest ruling, such an award will not be treated as performance-based compensation under Code Section 162(m). Consequently, public companies will not be able to deduct non-performance-based executive officer compensation in excess of \$1 million if the compensation plan or employment agreement under which that compensation is paid allows such payment without satisfaction of performance goals — even if the performance goals are, in fact, achieved.

I. Plans and Arrangements That May Need to be Amended

In light of this ruling, public companies that wish to preserve the deductibility of certain compensation paid to its covered officers may need to amend the following types of arrangements:

1. Shareholder-approved bonus plans;
2. Shareholder-approved equity plans;
3. Award agreements under these plans;
4. Employment agreements; and
5. Change-in-control and severance agreements.

II. Timing of Amendments and Transition Relief

Because the IRS and the U.S. Treasury changed their positions from prior guidance, they have provided a limited transition period before the new guidance becomes effective. The IRS will not enforce the new guidance under the following circumstances:

1. The service period to which a performance goal relates begins on or before January 1, 2009, or
2. The compensation is paid under an employment contract in effect on February 21, 2008, even if the service period begins after January 1, 2009. Renewal and extension provisions, however, including automatic renewals, are subject to the new ruling.

III. Action Items

Even with the transition period, public companies should begin to review their incentive plans and related arrangements to determine if they comply with the new ruling. Because many of these arrangements will need to be revised by December 31, 2008 to comply with Code Section 409A (see our November 2007 Executive Compensation Law Alert *"Treasury Provides Relief for Deferred Compensation Plans"*), the review for Code Section 162(m) compliance issues may be performed in conjunction with the review for Code Section 409A compliance. As such, public companies should consider taking the following actions:

1. Inventory the plans and arrangements described in Part I to determine whether compensation deductions may be at risk.
2. Determine whether it is desirable to continue to receive the tax deduction for non-performance-based compensation that exceeds \$1 million.
3. If the tax deduction is desirable, consult with counsel to determine the appropriate way to amend the arrangement to preserve the tax deduction.

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