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IRS Changes Rules for Qualifying as Section 162(m) Performance-Based Compensation

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Overview

Just-issued IRS Revenue Ruling 2008-13 (the Revenue Ruling) confirms a position taken by the IRS in a private letter ruling released last month that an incentive plan intended to comply with Section 162(m) requirements for "performance-based compensation" may not permit such compensation to be paid to a participant on termination without cause, termination for good reason or retirement (unless the performance conditions are also satisfied). This Revenue Ruling reverses a longstanding IRS position set forth in private letter rulings. Helpfully, this new position applies prospectively, as described below.

Background

Section 162(m) of the Internal Revenue Code imposes a $1 million annual limit on the compensation deduction permitted a public company employer for compensation paid to its chief executive officer and its other officers whose compensation is required to be reported to stockholders under the Securities Exchange Act of 1934 because they are among the four most highly compensated officers for the taxable year. (Generally, this will include the CEO and the three highest-paid officers other than the CEO, but will exclude the CFO.)

However, amounts that constitute "performance-based compensation" under Section 162(m) will not count toward the $1 million limit. Applicable 162(m) regulations describe a number of requirements that must be met in order for bonuses or other compensation plans to constitute "performance-based compensation," including a requirement that the plan must not permit the compensation to be paid if the performance goals are not met. The only explicit exceptions are that the compensation may be paid, even if the goals are not met, if the officer dies or becomes disabled, or if there is a change in control. Amounts actually paid on these events will not qualify as "performance-based compensation" under Section 162(m), but the presence of these triggers in the plans will not disqualify otherwise qualifying "performance-based compensation" plans.

In 1999 and again in 2006, the IRS issued private letter rulings--that is, advice to particular taxpayers that is also published for the general information of the taxpaying public--that permitted plans

otherwise providing "performance-based compensation" to go beyond the explicitly permitted exceptions in the regulations. These private rulings extended the protection to payments that would be made regardless of whether the performance targets were met to officers who experienced an involuntary termination of employment or a termination for good reason, and/or officers who retired. As was the case on death, disability and change of control, such payments would not be treated as "performance-based compensation," but the presence of such provisions in the plan and related agreements would not disqualify an otherwise qualifying "performance-based compensation" plan. However, the IRS revoked this position in the private letter ruling issued earlier this year.

What Revenue Ruling 2008-13 Requires--and When

As a result of the shocked response of taxpayers and their advisers to the issuance, without any notice or discussion, of the private letter ruling reversing this long-held IRS position, and the potential accounting impact of this immediate change, the IRS quickly issued the Revenue Ruling to clarify its position.

The Revenue Ruling confirms the IRS's revocation of its long-held position and holds that in order to qualify as "performance-based compensation," the incentives must be paid under a plan that permits payment to officers only if the plan's goals are achieved unless the officer dies, becomes disabled or there is a change in control. The Revenue Ruing makes it clear that related agreements under which benefits are provided to officers are considered part of the plan and that provisions prohibited by the Ruling will disqualify the plan, even if the events described never occur during the performance period.

The Revenue Ruling goes on to provide that this position will be effective prospectively. In particular, deductions with respect to otherwise qualifying "performance-based compensation" will NOT be disallowed if paid under a plan, agreement or contract that has payment terms similar to the terms prohibited by the Revenue Ruling, if either:

1. the performance period of the performance-based compensation begins on or before January 1, 2009, or
2. the compensation is paid pursuant to the terms of an employment contract in effect on February 21, 2008 (without respect to future renewals, or extensions--including those that occur automatically, absent actions by one of the parties).

Our Recommendations

Along with other practitioners, we are continuing to conduct a dialogue with the IRS and will provide updates to our clients on the implications of the Revenue Ruling. Although no immediate action is necessary, we currently recommend the following:

1. Review those programs that are intended to qualify as "performance-based compensation" under 162(m), and officer agreements that might provide for payment in lieu of compensation under such programs (including employment, severance, retention or similar agreements), in order to identify those provisions permitting payment of that compensation (or amounts in lieu thereof) on termination of employment or retirement.

This can become part of the review being done for documentary compliance with Section 409A, which involves many of the same agreements. Public company employers should continue to monitor events affecting this process.

2. Begin considering the kinds of modifications to these existing programs that will satisfy all parties. These may include: (i) allowing the Compensation Committee to take into account the effect of termination in exercising its negative discretion under "performance-based compensation plan," but no longer permit payment to be made unless the performance criteria are met; (ii) deferring the payment of compensation under such plans on termination events until a date when compensation paid to the officer is no longer subject to Section 162(m); or (iii) providing for a payment on such events that is not made under the plan and will not be considered a substitute for such payment.

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