ALERT

March 2008

Section 162(m): Severance Provisions Invalidate Performance Exception

On February 21, 2008, the IRS issued Revenue Ruling 2008-13 (the "Ruling") addressing the application of the performance-based compensation rules under Section 162(m) of the Internal Revenue Code of 1986, as amended (the "Code") to compensation otherwise qualifying as performance-based that is payable upon an executive's termination of employment without cause, resignation for good reason, or retirement. The Ruling holds that the mere existence of any such payment right causes the compensation to fail to qualify as performance-based for Code §162(m) purposes, even if the compensation is actually paid as the result of achievement of the relevant performance goal.

However, the Ruling exempts from its holding compensation paid (i) with respect to any performance period beginning on or before January 1, 2009 or (ii) pursuant to contracts in effect on February 21, 2008 (without respect to subsequent amendments). The events that led to the issuance of the Ruling, and the Ruling's implications for public company executive compensation planning, are discussed below.

Background

Code §162(m) generally prohibits a public company from deducting compensation in excess of $1,000,000 paid to a "covered employee" in any taxable year. A company's "covered employees" are its CEO and its three other most highly paid officers other than the CFO (who, under current law, is not a covered employee). However, compensation qualifying as "performance-based" is not subject to this limitation.

To qualify as "performance-based" for Code §162(m) purposes, compensation must be payable solely upon the attainment of one or more pre-established, objective performance goals established by a compensation committee composed solely of 2 or more outside directors pursuant to a plan approved by the company's shareholders following disclosure of the plan's materials terms to those shareholders.

Regulations issued under Code §162(m) state that compensation is not performance-based if the facts and circumstances indicate that the executive would receive all or part of the compensation regardless of whether the performance goal is attained. However, the regulations further state that compensation will not fail to be performance-based solely because the arrangement provides for the payment of the compensation upon the executive's "death, disability, or a change in ownership or control of the employer" without regard to attaining the performance goal (although if the compensation is actually paid pursuant to any such event — rather than as the result of achievement of the applicable performance goal — it does not qualify as performance-based).

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The IRS in 1999 issued a private letter ruling holding that the existence of a right to receive payment upon involuntary termination or resignation with good reason did not cause compensation otherwise qualifying as performance-based to fail to so qualify. PLR 199949014. The IRS stated in the ruling that the rationale for the holding was that such events "are … involuntary terminations similar to terminations as a result of death disability, or change in control."

In 2005, the IRS issued a private letter ruling holding (without stating a rationale) that the existence of a right to receive payment upon retirement did not cause compensation otherwise qualifying as performance-based to fail to so qualify. PLR 200613012.

However, in 2007, the IRS issued a private letter ruling reaching a conclusion directly contrary to the holding in PLR 199949014. PLR 200804004. The 2007 letter ruling contains no reference to either of the earlier letter rulings, and the analysis in the 2007 letter ruling simply states that "allowing for payment of [compensation] upon … termination … without cause or [resignation] with good reason does not meet the exception in … the regulations that allows compensation to be payable upon death, disability or change of ownership or control."

The Ruling

The release of the 2007 letter ruling in late January 2008 precipitated a wave of critical commentary by compensation specialists, since many public companies had adopted senior executive performance-based pay arrangements containing one or both of the payment triggers approved in the 1999 and 2005 letter rulings, based on the advice of their advisors that such triggers would not cause compensation otherwise qualifying as performance based for Code §162(m) purposes to fail to so qualify, which advice was in turn based on the 1999 and 2005 letter rulings.[1] Apart from the prospect of the loss of substantial future deductions on payments under such arrangements, the 2007 letter ruling jeopardized the validity of deductions claimed by many public companies on previously filed returns, creating the possibility that the financial statements of those companies might have to be restated to increase tax reserves.

The Ruling was issued in response to the concerns raised about the implications of the 2007 letter ruling for prior periods in which deduction claims were based on the 1999 and 2005 letter rulings. Although confirming the position reflected in the 2007 letter ruling, the Ruling grandfathers arrangements in which (i) the performance period begins on or before January 1, 2009, or (ii) the compensation is payable pursuant to the terms of an employment contact as in effect on February 21, 2008, unless such employment agreement is subsequently modified. Accordingly, the deductibility of compensation otherwise qualifying as "performance-based" within the meaning of Code §162(m) paid or payable under an arrangement that includes one or more of the accelerated payment triggers addressed in the Ruling should generally be unaffected by the release of the 2007 letter ruling with respect to prior taxable years or for taxable years ending on commencing in 2008. However, this grandfather rule may not be relied on for post-2/21/08 renewals or extensions, including renewals or extensions that occur automatically absent further action of one or more of the parties to the contract.

Implications

As previously described, the Ruling holds that the mere existence of a right to payment upon involuntary termination, resignation for good reason, or retirement in an arrangement otherwise qualifying as performance-based for Code §162(m) purposes causes the compensation to fail to so qualify, even if paid as the result of satisfaction of the applicable performance goal. Although not explicitly stated in the Ruling, one can infer from the discussion in PLR 200804004 that it is now the IRS's position that the existence of any non-performance based payment trigger other than death, disability, or a change in ownership or control (i.e., the regulatory exceptions noted previously) in any pay arrangement precludes the arrangement from satisfying Code §162(m)'s performance based exception. Accordingly, future senior executive pay arrangements intended to qualify for that exception should be structured to take this likely position into account.

Additionally, any public company intending to rely on Code §162(m)'s performance-based exception with respect to existing senior executive pay arrangements should review, or have its advisors review, those arrangements to determine whether any such rights exist with respect to payments that would not qualify for the Ruling's grandfather relief. To the extent possible, any such rights should be eliminated by amendment. Of course, eliminating any such rights of an executive contained in an existing agreement will in most cases require the executive's consent.

Arrangements that could cause compensation otherwise qualifying as performance-based to fail to so qualify include equity, performance unit, and similar awards that provide for accelerated vesting upon involuntary termination, resignation for good reason, or retirement as well as bonus awards that provide for payment upon any such event. In addition to vesting or payment rights of such a nature in the applicable plan or grant agreement, the existence of such a right in a

separate agreement, such as a severance agreement, would also result in disqualification. For example, if an executive's severance agreement entitles the executive to a pro-rated share of her annual bonus if her employment is involuntarily terminated, based on the portion of the period for which the bonus is paid that the executive had been employed, IRS would likely take the position that the bonus, even if paid as the result of actual satisfaction of a Code §162(m)-compliant performance target, does not qualify for Code §162(m)'s performance-based exception.

Stock options or stock appreciation rights not in-the-money at grant are not affected by the Ruling, since such arrangements do not require additional conditions to qualify as performance-based for Code §162(m) purposes. For example, a stock option or stock appreciation right that vests after three years of continuous service may provide for accelerated vesting upon involuntary termination, resignation with good reason, and/or retirement and still qualify as performance-based so long as it is not in-the-money at grant.

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1 Although a private letter ruling may be relied on only by the taxpayer to whom it is directed, taxpayers and their advisors generally view private letter rulings as representing the IRS's interpretation (albeit unofficial) of the legal issues on which it is ruling, especially where (as in the case of the 1999 letter ruling but not the 2005 letter ruling) a reasoned explanation of the basis for the holding is provided. Moreover, private letter rulings do constitute "authority" for purposes of the accuracy-related penalty provisions of the Code. Treas. Reg. §1.6662-4(d)(3)(ii) and (iii). Consequently, private letter rulings are as a practical matter often relied on by taxpayers and their advisors in structuring legal arrangements to achieve particular tax objectives.

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