A Littler Mendelson Time Sensitive Newsletter

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Revised IRS guidance regarding performance-based compensation could require changes in the financial planning strategies of publicly-traded companies.

Employee Benefits

A Littler Mendelson Newsletter

IRS Changes the Rules for Performance-Based Compensation

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Recent changes to the way in which the Internal Revenue Service (IRS) interprets "performance-based compensation" under Internal Revenue Code (IRC) Section 162(m) have narrowed the types of arrangements that may be classified as performance-based and will require publicly-held companies to reexamine these arrangements or jeopardize the financial soundness of current tax and financial planning methodologies.

What is the significance of IRC Section 162(m)?

IRC Section 162 allows a tax deduction by corporations and individuals for the ordinary and necessary expenses paid or incurred in carrying on any trade or business.

Subject to certain limitations, among the items allowable as a deduction under IRC Section 162 are salaries and other compensation for services rendered. This deduction had historically been unlimited. However, in response to calls for curbing excessive executive pay, Section 162(m) was signed into law on August 10, 1993, as part of the Omnibus Budget Reconciliation Act of 1993. Section 162(m) limits the amount that publicly-traded corporations can deduct as a compensation expense for a "covered employee" to \$1,000,000.

Who is a covered employee?

A "covered employee" is one who:

 as of the close of the tax year, is the chief executive officer of the tax-

- payer or is an individual acting in such capacity; or
- is one of the 4 highest compensated officers for the year (other than the chief executive officer).

Are there exceptions to the Section 162(m) limitation?

An exception exists under IRC Section 162 for "performance-based compensation" earned by a covered employee. To the extent that a covered employee's compensation is based upon the attainment of one or more performance goals, it does not count toward the \$1,000,000 limit

What are the specific criteria that determine whether compensation is performance-based?

Performance-based compensation must be paid to an employee solely as a result of meeting one or more preestablished, objective performance goals. In general, a performance-based arrangement must:

- be established by a committee of outside directors of the board of directors;
- be disclosed to shareholders and approved by a majority vote; and
- require certification by the compensation committee of the corporation that the performance goals have been met.

Compensation is not performance-based



if, based on all the facts and circumstances, it is established that:

- an employee would receive all or part of the compensation, regardless of whether the performance goal(s) is satisfied: and
- payment of compensation is only nominally or partly conditioned upon attainment of the performance goal(s).

Will an award of compensation fail to be considered performance-based if the overall plan or contract pursuant to which it is paid allows for payment on events other than attainment of performance goals?

An award of compensation will not fail to be performance-based if the plan or other arrangement pursuant to which it is paid also allows for payment of the award upon death, disability or a change of control, prior to attainment of the performance goal(s). Note that if compensation is actually paid upon one of these events, however, it will not be considered performance-based. The exemption means that *all* compensation payable pursuant to the arrangement will not fail to qualify as performance-based simply because it *may* be paid upon death, disability or change in control.

In private letter rulings, the IRS took the similar position that payment upon an employee's involuntary termination, or termination by the employee for "good reason," was similar to payment on death, disability or change in control. Therefore, compensation under an arrangement that also allowed for payment upon one of these occurrences, without satisfaction of performance goals, would not fail to be performance-based (unless it was, in fact, paid for one of these reasons).

How has the IRS' position changed?

On January 25, 2008, the IRS issued Private Letter Ruling 200804004, which set forth a narrower interpretation of what constitutes performance-based compensation, effectively overruling its prior guid-

ance. Under its most recent guidance, the IRS ruled that compensation that *may* be paid upon an involuntary termination without cause, upon an executive's voluntary termination for good cause, or upon voluntary retirement, and prior to satisfaction of performance goals, *cannot* be performance-based. Therefore, even if compensation under the arrangement is actually paid upon satisfaction of performance goals, it will not be performance-based because there was a *possibility* that it could be paid on one of these events, before performance goals had been met.

Equally important, the IRS' revised position did not clarify that it would be prospective in nature, meaning that arrangements which had been carefully crafted to meet then-current IRS ruling positions could be found to be nondeductible.

A wave of criticism and confusion on the part of practitioners and corporate executives resulted in the transition relief of Revenue Ruling 2008-13. In this ruling, the IRS affirms its decision in PLR 200804004, but clarifies that the new interpretation of performance-based compensation will apply only prospectively. Specifically, Revenue Ruling 2008-13 clarifies that the new restrictions will not apply to plans, agreements, or contracts in which:

- the performance period to which the compensation applies 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 (without regard to any future renewals or extensions).

What employer action is recommended in response to this change?

Publicly-held companies may need to take a closer look at their performance-based arrangements. Future performance-based arrangements that are intended to qualify for the IRC Section 162(m) deduction must be drafted in accordance with the new restrictions. Also, existing arrangements should be reviewed to determine whether they fall under the transition relief of Revenue Ruling 2008-13. Current

performance-based arrangements that do not qualify for transition relief should be reviewed with an eye toward modifications that will allow additional compensation to be qualified as performance-based.

Employers should conduct a careful review of plans, agreements, and contracts for compliance with the administrative requirements of performance-based arrangements, which include the requisite shareholder approval, establishment of performance criteria by outside directors, and certification of the attainment of performance goals.

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