February 29, 2008

MEMORANDUM TO CLIENTS

RE: Permissible Payment Events for Performance–Based Compensation Under Code Section 162(m) – The Dust Settles

Last week, the IRS issued Revenue Ruling 2008-13 (the "Revenue Ruling"), addressing the scope of the "performance-based compensation" exception to the $1 million deduction limitation under Code Section 162(m). Specifically, the Revenue Ruling limits the events that may trigger vesting and payment of performance-based compensation under a bonus or incentive plan regardless of whether a performance goal is met. The Revenue Ruling will not apply retroactively and applies generally to performance periods beginning after January 1, 2009.

The Revenue Ruling follows an outcry from public companies and their advisors over a recent private letter ruling ("PLR") on this issue. See PLR 200804004 (Sept. 21, 2007). The new PLR contradicts the IRS position in two prior PLRs that many public companies had used as a guide in designing their incentive plans. Following issuance of this PLR, the business and legal communities requested that (1) the IRS reconsider its position on the issue, or (2) alternatively, issue generally applicable guidance applying prospectively only. We summarize the IRS response below.

Background – Subject to certain exceptions, Section 162(m) limits to $1 million the amount of deductible compensation that a public company may pay to certain high-level employees each year. The major exception under Section 162(m) allows a public company to deduct, in addition to the $1 million annually, all of an employee's "performance-based compensation." Performance-based compensation is compensation that is *payable solely* upon achievement of one or more performance goals, but only if the goals are pre-established and objective, and if certain other requirements are satisfied (for example, the performance goal is determined by the company's compensation committee).

Consistent with the "payable solely" requirement, the regulations under Section 162(m) provide that compensation is not performance-based compensation if the facts and circumstances indicate that an employee would receive some or all of the compensation regardless of whether the performance goal is met. Under an important exception to this rule, compensation may still be performance-based even if it may be paid on the employee's death, disability, or a change of control – regardless of whether the performance goal is met. Of course, any compensation *actually* paid based on the occurrence of one of these events is not considered performance-based.

IRS Position – The Revenue Ruling holds that compensation is not performance-based under Section 162(m) where it may be paid under an incentive or bonus plan not only when a performance goal is met, but also where the employee (1) is involuntarily terminated without "cause" (the definition of "cause" in the ruling does not include the executive's poor performance), (2) voluntarily resigns for "good reason," or (3) retires. The crux of the holding is that compensation payable under a bonus plan with these type of payment triggers – including

compensation that is ultimately paid upon the satisfaction of the performance goal – is not performance-based because of the mere existence of these potential payment triggers.

Consistent with the new PLR, the Revenue Ruling states that an employee's termination without cause, resignation for good reason, or retirement, are not events included in the exception under Section 162(m) for death, disability and change in control (i.e., permissible vesting events). Therefore, the IRS holds that compensation that may vest and be paid on such events is not performance-based compensation under Section 162(m). This language strongly suggests that other events not included in the exception that cause vesting and payment of incentive awards regardless of whether a performance goal is met would also be found by the IRS to be impermissible. The IRS provided little additional analysis for these conclusions, stating that (1) an involuntary termination without cause may occur or a good reason may arise (e.g., a reduction in title or base salary) as the result of the employee's poor performance and failure to meet the performance goal, and (2) retirement generally is a voluntary action within the control of the employee.

Transition Relief – A key concern arising from the recent PLR was whether the IRS' change in position would be applied to existing incentive arrangements containing the impermissible provisions. If so, many public companies that designed and implemented incentive arrangements based on the IRS position in the prior PLRs – a proposition which is somewhat risky to begin with – might find that they have large compensation expenses that cannot be deducted with related accounting and tax reserve issues.

Although the substantive result of the Revenue Ruling is dissatisfying to public companies, the IRS did provide fairly generous relief on the effective date. Specifically, the Revenue Ruling indicates that its holding will not be applied retroactively to disallow deductions for amounts that otherwise meet the requirements to be considered performance-based under Section 162(m) and that are paid under a plan that has payment terms similar to those described in the Revenue Ruling if either: (1) the performance period for the compensation begins on or before January 1, 2009, or (2) the compensation is paid according to the terms of an employment contract as generally in effect on February 21, 2008 (disregarding future renewals or extensions, including so-called "evergreen" renewals). Thus, payments under a calendar year annual incentive plan for 2009 are protected, not only payments under plans for prior periods.

Next Steps – The effective date relief in the Revenue Ruling gives public companies some time to assess its impact on their bonus and incentive plans. However, public companies should begin to look closely at their plans to identify provisions that may vest executives in an amount regardless of whether a performance goal has been satisfied. These types of provisions include the accelerated vesting and payment at target levels of incentive pay upon

- an involuntary termination other than for cause,
- a voluntary resignation for good reason,
- retirement, or
- some other event other than death, disability, change in control.

We note that provisions permitting a pro-rata incentive payment based on the portion of the performance period during which the employee actually performed services should be acceptable as long as payment is still conditioned on achievement of the performance goal.

In addition to bonus and incentive plan documents, other documents that may contain accelerated vesting and payment provisions – including award agreements, employment agreements, change in control agreements, severance plans/arrangements and the like – should also be carefully reviewed. Public companies should consider whether to revise or remove these provisions and the steps required for doing so (e.g., need for employee consent, board/shareholder approval requirements).

In recent years, the IRS has begun to increasingly audit public companies on Section 162(m) issues and to take conservative positions on debatable issues under Section 162(m). Many companies' published compensation policies indicate that section 162(m) deductibility is required for the company's programs generally (although some state to the contrary). Moreover, pending legislation would substantially tighten the rules under Section 162(m). Thus, public companies should consider limiting their exposure on this and other grey areas under Section 162(m).

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Please call one of the following, or the Groom attorney you regularly contact, if you have any questions about the Revenue Ruling or its impact on your executive compensation arrangements.

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