

IRS Issues Formal Guidance on Performance-Based Compensation; New Rules Apply Prospectively

The Internal Revenue Service has ruled that compensation payable to covered employees of publicly held corporations upon a termination without cause, termination for good reason or voluntary retirement, without regard to the attainment of the relevant performance goals, does not qualify for the “performance-based compensation” exception under Section 162(m) of the Internal Revenue Code. Revenue Ruling 2008-13 formalizes and expands upon the position taken by the IRS earlier this year in Private Letter Ruling 200804004.

What Is Section 162(m)?

Section 162(m) generally prohibits a publicly held corporation from deducting compensation paid to certain covered employees in excess of \$1 million in any year. The covered employees of a publicly held corporation typically include its principal executive officer and three other highest paid officers (excluding the principal financial officer).

What Is the Performance-Based Compensation Exception Under Section 162(m)?

Payments that qualify as performance-based compensation do not count toward the \$1 million limit under Section 162(m). Generally, in order to qualify as performance-based compensation, compensation must be payable solely on account of the attainment of one or more pre-established, objective performance goals. The regulations under Section 162(m) provide that compensation does not fail to be performance-based compensation because an arrangement provides that the compensation could be paid upon death, disability or a change in control, although compensation actually paid upon the occurrence of these events prior to the attainment of the relevant performance goals counts toward the \$1 million limit.

In two prior private letter rulings, the IRS held that compensation paid under a plan upon attainment of performance goals would be considered performance-based compensation under Section 162(m), provided that the compensation met the requirements for performance-based compensation under Section 162(m), even though the compensation could be paid upon an employee’s termination without cause, termination for good reason or retirement. The IRS also held that compensation actually paid upon those events prior to the attainment of the performance goals would not, however, qualify as performance-based compensation and would count toward the \$1 million limit.

In PLR 200804004 and Revenue Ruling 2008-13, the IRS abruptly abandoned these prior positions, instead concluding that no payment to a covered employee will qualify as performance-based compensation under Section 162(m) if the payment could be made upon the covered employee’s termination without cause, termination for good reason or voluntary retirement, without regard to whether the relevant performance goals are attained.

What Is The Significance of Revenue Ruling 2008-13?

As a result of Revenue Ruling 2008-13, compensation that may be paid to a covered employee on account of the employee’s termination without cause, termination for good reason or retirement, without regard to the attainment of the relevant performance goals, will not qualify as performance-based compensation under Section 162(m). This remains true even if the termination event does not occur and the employee is paid based on satisfaction of the relevant performance goals.

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When Does Revenue Ruling 2008-13 Apply and Did the IRS Provide Transition Relief?

Revenue Ruling 2008-13 only applies prospectively. In addition, the IRS has provided transition relief for compensation that otherwise meets the performance-based compensation exception under Section 162(m). The IRS held that Revenue Ruling 2008-13 will not be applied to disallow a deduction for any such compensation if either: (1) the performance period for such compensation begins on or before January 1, 2009; or (2) the compensation is paid pursuant to an employment contract as in effect on February 21, 2008 (without regard to future renewals or extensions, including renewals or extensions that occur automatically). Although it is not clear, it does not appear that an amendment to an employment contract will terminate the transition relief.

What Should Publicly Held Corporations Do Next?

We recommend that all publicly held corporations with arrangements that are intended to qualify for the performance-based compensation exception under Section 162(m) consider the following:

- **Identify and Review Affected Plans and Agreements.** Identify all arrangements, particularly incentive compensation plans, employment agreements and severance arrangements, under which covered employees (and employees who could become covered employees) may receive compensation and determine whether such arrangements permit performance-based compensation to be paid upon a termination without cause, termination for good reason or voluntary retirement.
- **Amend Plans and Agreements.** Determine whether the corporation desires to amend any arrangement affected by Revenue Ruling 2008-13 for performance periods beginning after January 1, 2009 and any employment agreement in effect on February 21, 2008 if its term is extended or renewed. In addition, consider whether employee consent will be required to amend the arrangement(s).
- **Securities Laws Considerations.** Consider the impact of Revenue Ruling 2008-13 on proxy statements, periodic reports, prospectuses and other public disclosures.
- **Tax Treatment of Compensation.** Consult with tax accountants and auditors to discuss the impact of Revenue Ruling 2008-13 on the deductibility of compensation payable to covered employees in excess of the \$1 million limit.

This Client Alert is for general information purposes and should not be regarded as legal advice. If you have any questions, please contact Anthony C. Ciriaco (614.464.6429), Wendy M. Swary (614.464.6495), Alan D. Duffy (614.464.5425), Amy M. Stuckey Swank (614.464.6461), or your Vorys relationship attorney.

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