

Performance-Based Compensation Exemption in Severance Protection Cases

IRS Reverses Its Position

By Stephen F. Herbes

In an abrupt about-face from its position in earlier private letter rulings, the IRS ruled, in Private Letter Ruling (PLR) 200804004 (January 25, 2008) and Revenue Ruling 2008-13 (February 21, 2008), that performance-based compensation that is required under a compensation plan to be paid to an executive when employment is terminated without cause or terminated by the executive for good reason is not eligible for the performance-based compensation exemption under IRC section 162(m).

IRC Section 162(m) and Executive Compensation

Generally, IRC section 162(a)(1) allows a company to deduct ordinary and necessary expenses incurred in carrying on its trade or business. In the case of publicly held corporations, however, IRC section 162(m) limits the deduction of certain employee compensation expenses to \$1 million annually per "covered" employee. The limit in IRC section 162(m)(1) generally applies to the company's CEO and four highest-paid executive officers. Performance-based compensation is not subject to the \$1 million limit if it meets certain requirements, however.

In 1995, the IRS issued regulations providing, in part, that performance-based compensation, in order to qualify for the exemption from the \$1 million limit, must be paid solely on account of the attainment of one or more pre-established, objective performance goals [Treasury Regulations section 1.162-27(e)(2)(i)]. If the performance-based compensation is only nominally or partially contingent on attaining a performance goal, then none of the compensation is considered performance-based [Treasury Regulations section 1.162-27(e)(2)(v)]. The regulations provide a notable exception: Compensation does not cease to be performance-based merely because the

plan allows it to be paid upon death, disability, or change of ownership or control [Treasury Regulations section 1.62-27(e)(2)].

Prior to PLR 200804004 and Revenue Ruling 2008-13, the IRS had taken the position that termination by a company without cause and termination by an executive for good reason were both involuntary terminations, similar to terminations

Private Letter Ruling Background

The company in PLR 200804004 had adopted a variety of incentive awards, including performance-share and performance-unit awards. These awards were intended to be qualified performance-based compensation under IRC section 162. The company entered into an employment contract with its executive which provided that if the execu-



as a result of death, disability, or change in control [see PLR 199949014 (Dec. 13, 1999) and PLR 200613012 (March 31, 2006)]. Therefore, the IRS had ruled that performance-based compensation received by an executive when he was terminated by the company without cause or terminated his employment for good reason—provided the compensation met the other requirements of IRC section 162—was fully deductible. In January 2008, the IRS, without explanation, reversed its earlier position by issuing PLR 200804004.

tive's employment was terminated by the company other than for cause or by the executive for good reason, any performance goal under any outstanding performance-share or performance-unit awards would be deemed to have been achieved, and the awards would vest at termination to the extent the awards would have become vested in accordance with the executive's regular vesting schedule. Not only did the IRS rule that the performance-share and performance-unit awards payable upon the executive's termination were not performance-based compensation,

it also ruled that any performance-share and performance-unit awards payable under the employment contract, including performance-share and performance-unit awards previously paid to the executive, were not performance-based compensation. As a result, according to the IRS, the maximum amount of compensation that the company could have or should have deducted with respect to its executive in any taxable year was \$1 million, inclusive of the performance-share and performance-unit awards.

PLR 200804004 provoked an outcry from tax practitioners, in part because of the ruling's financial accounting implications for public companies under the recently promulgated FASB Interpretation (FIN) 48, *Accounting for Uncertainty in Income Taxes—An Interpretation of FASB Statement No. 109*, which requires certain questionable tax positions to be reported on a company's financial statements.

Revenue Ruling 2008-13 Delays Effective Dates

In part to alleviate practitioners' concerns about FIN 48, the IRS issued Revenue Ruling 2008-13 on February 21, 2008. Like PLR 200804004, Revenue Ruling 2008-13 concludes that a compensation plan with certain severance protection features is not a qualified performance-based compensation plan. When the compensation plan provides that, even if a performance goal is not attained, the award or bonus will still be paid if the company experiences a change of ownership or control, the award or bonus will not be treated as performance-based compensation under IRC section 162(m) if the employee is terminated by the company without cause, or if the employee voluntarily terminates employment for good reason. The IRS alleviated some of the FIN 48 concerns by limiting Revenue Ruling 2008-13 to compensation plans with similar severance protection features, in which

the performance period for such compensation begins after January 1, 2009, or in which the compensation is paid pursuant to the terms of an employment contract not in effect on February 21, 2008.

In light of the financial accounting reporting rules (including FIN 48) and the various securities disclosure requirements (including the proxy-statement disclosure rules for public companies), companies should evaluate any severance protection features in their performance-based compensation plans and consider how such features may affect their reporting requirements. In addition, companies should keep these recent decisions in mind as they review and finalize their compensation plans for 2008. □

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