

# PUBLICATION

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## IRS Issues New §162(m) Rulings: Public Companies Need to Review Executive Agreements Now

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In the past several weeks, the IRS has issued two rulings which provide a more restrictive interpretation of the rules governing incentive compensation than had previously existed under Internal Revenue Code Section 162(m). Section 162(m) limits a public company's tax deduction to \$1 million per year for compensation paid to a covered employee. A "covered employee" includes a company's chief executive officer and its other four highest compensated officers. However, this \$1 million limitation does not apply to "performance-based" compensation. As a result, many public companies have adopted bonus and incentive plans intended to satisfy the performance-based compensation exception. The new rulings adopt the position that any agreement that allows for payment as a result of either termination without cause or termination for good reason fails to qualify as performance-based compensation under Section 162(m).

The first ruling was a private letter ruling (PLR) in which a company entered into an employment agreement with an executive who had received performance shares under the company's performance-based incentive compensation plan. Under the agreement, a portion of the executive's performance shares would vest in the event the executive was terminated without cause or for good reason. The IRS determined that this provision did not meet the performance-based compensation exception in the applicable regulations that permits compensation to be paid upon death, disability, or change in the ownership or control of the company. Accordingly, the IRS held that compensation paid to the executive was not performance-based compensation, regardless of whether the performance criteria were satisfied because, under the agreement, it was possible for the executive to receive the compensation without having met the performance criteria.

Following the PLR, the IRS released Revenue Ruling 2008-13, confirming its position in the PLR and setting forth transition relief for compliance. In the Revenue Ruling, the IRS affirmed the position it had taken in the PLR, holding that any agreement that allows for payment as a result of termination without cause or termination for good reason does not qualify as performance-based compensation under Section 162(m). The IRS further held that an agreement allowing payment upon voluntary retirement also does not qualify as performance-based compensation under Section 162(m). As a result, an employer who enters into an agreement providing for payment to a covered employee upon termination without cause, termination for good reason, or voluntary retirement would not be eligible to use the performance-based compensation exception under Section 162(m). Instead, the deduction for such compensation would be limited to \$1 million.

The transition relief provided by the Revenue Ruling exempts the following arrangements from compliance with these new rulings:

- Performance-based compensation for which the performance period begins on or before January 1, 2009; and
- Compensation payable pursuant to contracts as in effect on February 21, 2008 (without regard to renewals or extensions, whether automatic or by agreement).

Any modification, however, to agreements or plans already in existence will be subject to the holding in the Revenue Ruling. Public companies should start now to review the impact of these rulings on all compensation arrangements and employment contracts, and revise them to the extent necessary for 2009 and future periods.

