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— A NEED TO REVISIT TERMINATION PROVISIONS —

NEW IRS SECTION 162(M) RULING

Entitlement to Incentive Compensation on Termination of Employment May Result in Loss of Treatment as Performance-Based Compensation under Section 162(m)

In what may be a substantive reversal of previous guidance, the IRS recently issued a private letter ruling (PLR 200804004) that concluded that all compensation payable to an executive under an incentive plan will not be treated as “performance-based compensation” under Section 162(m) of the Internal Revenue Code if it is payable in the event of certain severance scenarios, regardless of actual performance. The PLR indicates that compensation payable under the incentive plan does not qualify as “performance-based compensation” even in years in which the executive’s employment is not terminated and the performance goals are attained. The IRS had previously provided contrary guidance in several private letter rulings, which suggests that this is a major shift in interpretation.

According to the PLR, the executive’s employment agreement provided for payment of incentive plan compensation upon termination of employment by the company without cause or by the executive for good reason based on deemed achievement of the plan’s target performance goals. The rationale in the ruling is that the “target” compensation would be payable regardless of actual performance, which violates the Section 162(m) requirement that compensation “must be paid solely [emphasis added] on account of the attainment of one or more preestablished, objective performance goals.”

If the termination of employment provision is in either a standard form of agreement or the plan itself, it is likely that all payments under the plan would cease to be 162(m) qualified under the ruling. If, on the other hand, the provision is unique to a single executive, the company would presumably be able to take the position that the taint is limited to that executive.

Although a private letter ruling only applies to the taxpayer to whom it is issued, at least one major accounting firm has issued an alert about the ruling, and we anticipate that this Section 162(m) development will be an audit item. The principles in the ruling would apply to annual and long-term incentive plans (including performance share plans) that provide for payment of compensation under a severance scenario or upon retirement. (Section 162(m) regulations provide that incentive plans with provisions for payment of target compensation in the event of death, disability or a change in control, regardless of performance, do not violate this requirement except in the year the event occurs.)

We suggest that companies consult with their tax advisors and auditors immediately to review the provisions of incentive plans intended to satisfy Section 162(m), the provisions of related award agreements, and employment and severance agreements. The review should be undertaken promptly by calendar year companies since the terms of their Section 162(m) incentive plan awards must be established no later than the end of March 2008.

This letter is intended to alert compensation professionals about developments that may affect their companies and should not be considered or relied upon as legal advice. Specific questions about Section 162(m) performance-based compensation should be discussed with appropriate counsel and tax advisors. General questions may be directed to Richard Alpern in our New York offices at 212-299-3599 or by e-mail at ralpern@fwcook.com, or Jeffrey Kanter at 212-299-3709 or by e-mail at jmkanter@fwcook.com. Copies of this letter and other published materials are available on our website, www.fwcook.com.