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IRS REVENUE RULING 2008-13
Planning Considerations for Reducing Loss of Treatment as
Performance-Based Compensation Under Section 162(m)

Background

IRC Section 162(m) provides that annual compensation paid to a “covered employee” (i.e., the company’s CEO and the three additional executives employed at the end of the year who appear in the company’s proxy statement for that year, excluding the CFO) in excess of \$1 million is only tax-deductible if the compensation is “performance-based.” In order for compensation to be performance-based:

- It must be granted under a plan, the material terms of which have been approved by shareholders
- It must be contingent on attainment of one or more pre-established objective performance goals
- The performance goals and the amount of compensation payable must be approved by a compensation committee that consists of two or more “outside directors”
- The compensation committee must certify that the performance goals have been attained prior to payment

On February 21, 2008, the IRS issued Revenue Ruling 2008-13, which provides that compensation will not be treated as performance-based under Section 162(m) if it is payable, regardless of actual performance, in the event of termination of employment by:

- The company without “cause”
- The employee with “good reason”
- The retirement of the executive

The Revenue Ruling represents a major change in interpretation by the IRS which had previously issued contrary guidance in private letter rulings issued in 1999 and 2005.

The loss of treatment as performance-based compensation (and the loss of tax deductibility if the covered employee’s total compensation for the year in which the compensation is paid exceeds \$1 million) applies to all years, not just the year in which termination of employment occurs.

If the termination of employment provision is in a standard form of award agreement, an incentive compensation plan or a severance plan, it is likely that all payments under the incentive compensation plan would cease to qualify as performance-based compensation under the Revenue Ruling. If, on the other hand, the provision is unique to a single executive (in an award agreement, an employment agreement or a severance agreement), the company would presumably be able to take the position that the taint is limited to that executive.

The Revenue Ruling stipulates that the loss of treatment as performance-based compensation will not be applied to compensation for performance periods that begin on or before January 1, 2009 or for any compensation paid under the terms of employment contracts effective on February 21, 2008 (disregarding future renewals or extensions, including those that are automatic).

Planning Considerations

We recommend that companies consult with their tax advisors and legal counsel promptly to review the provisions of all incentive compensation plans intended to satisfy Section 162(m), the provisions of related award agreements, employment agreements and severance plans and agreements (including change-in-control (CIC) plans and agreements). Since the Revenue Ruling does not apply to performance periods that begin on or before January 1, 2009, companies may consider first focusing on employment agreements and severance and CIC plans and agreements that will expire or be up for renewal after February 21, 2008.

Companies may consider the following approaches to preserve the tax deductibility of incentive compensation intended to be treated as performance-based compensation:

- Pro-rating annual and long-term incentive awards based on actual performance through the end of the performance period (or if applicable, based on actual performance through the termination date) and the time elapsed during the performance period at termination
 - Companies should consider the impact of this amendment for executives who terminate employment early in the performance period. For example, companies should consider whether the executive must be employed for a minimum portion of the performance period in order to be eligible for a payment
 - Paying awards based on actual performance through the end of the performance period may create a significant delay between the executive's termination and the payout of the award in the case of a multi-year performance period
- Modifying severance and double-trigger CIC provisions to forfeit incentive compensation awards that are intended to qualify as performance based; appropriate severance compensation could then be based on compensation elements that are not tied to incentive compensation (e.g., multiple of base salary; flat dollar amount)
 - While single-trigger CIC payments would not violate the terms for performance-based compensation under the Revenue Ruling, we do not recommend this approach; single-trigger benefits are inconsistent with best practice

- The impact of the Revenue Ruling with regard to severance formulas is not clear; assuming that the inclusion of a pro-rata or multiple of target bonus in a severance plan calculation would impact the tax deductibility of an incentive compensation award, companies may consider replacing it with compensation elements not tied to incentive compensation for the year of termination (e.g., multiple of base salary; flat dollar amount; average incentive compensation for prior years)

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 Eric Winikoff at 212-299-3718 or by e-mail at ewinikoff@fwcook.com, or Richard Alpern at 212-299-3599 or by e-mail at ralpern@fwcook.com. Copies of this letter and other published materials are available on our website, www.fwcook.com.