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IRS EXPLAINS CHANGE IN POSITION – GUIDANCE TO COME

Action Plan for "Tainted" Performance-Based Compensation

On February 14, 2008, a representative of the Internal Revenue Service (IRS) explained why the IRS recently changed its long-standing position regarding the deductibility of performance-based compensation where the compensation could be paid upon the executive's involuntary termination, without attaining the performance goal.

- We recommend that companies wait for additional guidance before making changes to existing arrangements to comply with the position in the ruling.
- However, the IRS may take the position that action is required for existing arrangements (to eliminate the possibility of payment without attaining the performance goal) no later than 90 days after the beginning of the performance period (by March 31, 2008, for many arrangements).
- See Action Plan below for steps companies should consider taking now in anticipation of additional IRS guidance.

Background

On January 25, 2008, the IRS released to the public a private letter ruling, PLR 200804004, which reversed its prior position and held that compensation paid to an executive *upon attainment of a performance goal* will not be considered performance-based compensation for purposes of Section 162(m), where under the terms of an employment agreement the compensation could be paid to the executive upon termination without cause or for good reason regardless of actual performance. Because the employment agreement included the possibility of payment regardless of actual performance, the performance shares and units described in the ruling do not qualify as performance-based compensation.

Performance-Based Compensation

Section 162(m) of the Internal Revenue Code limits the amount of compensation that a public company can deduct for certain executives to no more than $1 million. Generally, the limit applies to compensation paid to the chief executive officer and the three highest-paid officers for the year (other than the chief executive officer and the chief financial officer).

The deduction limit does not apply to qualified "performance-based" compensation. For compensation to be considered performance-based, the arrangement must satisfy a number of technical requirements. The ruling focuses on the requirement that performance-based compensation must be paid *solely* on account of attaining one or more objective performance goals.

In the facts presented in the ruling, an executive was awarded performance shares and units under an incentive plan, which were intended to be qualified performance-based compensation. The company also entered into an employment agreement with the executive, which provided that if the executive's employment was terminated by the company other than for "cause" or by the executive for "good reason," any performance goal relating to outstanding performance shares or units would be "deemed to be achieved at target" level regardless of actual performance.

As discussed in the ruling, the regulations provide that compensation does not satisfy the performance goal requirement if the facts and circumstances indicate that the employee would receive all or part of the compensation regardless of whether the performance goal is attained. Further, if the payment of compensation under the award is only nominally or partially contingent

on attaining a performance goal, none of the compensation payable under the award will be considered performance-based compensation. The regulations include an exception for compensation payable upon death, disability, or change of ownership or control. Although compensation actually paid on account of those events prior to attainment of the performance goal would not satisfy the performance goal requirement, such a provision does not "taint" the award with respect to payments made on account of actual attainment of the performance goals.

The ruling held that compensation paid to the executive would not be considered performance-based compensation for purposes of Section 162(m), even if the executive does not terminate employment, but instead satisfies the performance goals and is paid performance shares and units based upon attaining the performance goals.

The IRS position in the ruling appears inconsistent with two private letter rulings released in 1999 and 2006, where the IRS concluded that compensation paid on the achievement of performance goals would still be performance-based even if it could be paid on termination without cause or termination by the executive for "good reason" without regard to actual performance.

IRS Comments

On February 14, 2008, Kenneth M. Griffin, Associate Chief Counsel of the Executive Branch of the Internal Revenue Service, discussed the ruling at a webcast sponsored by CompensationStandards.com. Mr. Griffin is listed as the author of PLR 200804004. His comments during the webcast were not made in his capacity as a representative of the IRS. Below are some of our notes about his comments:

- A lot of thought went into the ruling, and the ruling was reviewed at higher levels of authority within the IRS than typical for this type of ruling.
- The IRS is currently circulating a draft of additional guidance to be released publicly regarding this issue.
- The IRS expects to issue the additional guidance within the near future, hopefully by the end of February.
- Mr. Griffin explained that the concern that prompted the ruling is that even though the possibility of payment without attaining the performance goal would be due to "involuntary" circumstances, there is a real possibility that the payment could be made on account of "poor performance," which does not satisfy the requirement that compensation be paid solely on account of attainment of one or more performance goals. In contrast, payment for "poor performance" is not a concern where compensation is payable upon one of the limited exceptions identified in the regulations for death, disability, or change in ownership or control.
- In addition to termination without cause or for good reason, a provision in an agreement that pays the target amount (regardless of actual performance) if the employee terminates employment during the performance period due to retirement or other reasons could be problematic.
- If an arrangement providing for payment upon change in ownership or control (regardless of actual performance) includes a "double-trigger" (*e.g.*, no payment is made unless a change in control occurs and following the change in control the executive is terminated involuntarily), the effect of the provision may need to be re-assessed at the time of a change in control.
- The extent to which the ruling may be applied retroactively is not yet clear. Mr. Griffin recommended that taxpayers wait for additional IRS guidance before making any changes to current arrangements.

Action Plan

This change in position is causing much uncertainty for public companies because:

- Many executive employment agreements include the type of severance provision described in the ruling (payment of all or a portion of a performance-based award at target level as part of severance pay for an involuntary termination).

- The release of the ruling now calls into question the company's federal tax deduction where this type of arrangement exists.
- This change in position may have an impact on the company financial statements because of the tax benefit associated with the expected tax deduction (*i.e.*, the previously booked expected tax benefit may need to be reversed or revised).
- It is not yet clear whether the position taken in the ruling will be applied retroactively or only prospectively.

In anticipation of additional IRS guidance, the company should consider the following:

1. Review all employment agreements, plan documents, individual award agreements (including performance-based equity and non-equity awards), and change in control arrangements for executives that are or may become subject to the limitations of Section 162(m) and identify provisions that may need to be changed.
2. Discuss the potential tax deduction and financial statement issues with the company's independent auditor and the preparer of the company's tax return.
3. Make a list of provisions that may need to be changed, and determine possible "fixes" for consideration.
4. Coordinate any potential changes with the company's compliance efforts for Section 409A (nonqualified deferred compensation tax law requirements).
5. Communicate the potential changes to executives. In many cases, negotiation between the company and the executive may be required.
6. Consider potential issues in connection with any upcoming mergers or acquisitions.
7. Determine whether shareholder approval will be required for new agreements or amendments to existing arrangements.
8. Arrange to obtain compensation committee approvals for new agreements or amendments to existing arrangements.
9. Determine applicable SEC reporting and timing requirements for new agreements or amendments to existing arrangements.
   - Form 8-K (4-day reporting)
   - Proxy Statement (compensation discussion and analysis)
   - Form 10-K or 10-Q (material contracts)
10. Watch for additional IRS guidance.

We encourage you to monitor developments in this area and to be on the lookout for additional IRS guidance. If you have not already done so, prepare an action plan in coordination with your advisors. If you have any questions concerning this alert, or compliance with Section 162(m) or Section 409A, please contact any of the individuals listed on this alert.

This memorandum was not intended or written to be used, and cannot be used, for the purpose of avoiding tax-related penalties under federal, state, or local tax law.

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