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HRO Alert

IRS PROVIDES TRANSITION RELIEF FOR “TAINTED” PERFORMANCE-BASED COMPENSATION

On February 21, 2008, the Internal Revenue Service (IRS) released additional guidance *confirming, expanding, and providing transition relief* for its recent change in position regarding the deductibility of performance-based compensation under Section 162(m) of the Internal Revenue Code where the compensation could be paid, regardless of actual performance upon the executive's (i) involuntary termination without “cause;” (ii) voluntary termination for “good reason;” or (iii) voluntary retirement.

Section 162(m) limits the amount of compensation that a public company can deduct for certain “covered” executives to no more than \$1 million. The deduction limit does not apply to qualified “performance-based” compensation. For compensation to qualify as performance-based, the arrangement must satisfy a number of technical requirements, including a requirement that the compensation must be paid *solely* on account of attaining one or more preestablished, objective performance goals.

The additional guidance follows the release of private letter ruling 200804004 on January 25, 2008. The private letter ruling changed a long-standing IRS 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 upon an involuntary termination without “cause” or termination for “good reason,” regardless of actual performance.

See our HRO Alert dated February 20, 2008, “IRS Explains Change in Position – Guidance to Come: Action Plan for ‘Tainted’ Performance-Based Compensation” for additional information, including an action plan.

What the Revenue Ruling Covers

In summary, Revenue Ruling 2008-13, which applies to all taxpayers:

- **Confirms the IRS position for without “cause” and “good reason.”** Because an involuntary termination without “cause” or a “good reason” termination may arise as a result of the executive's poor performance and failure to meet the performance goal, the compensation covered by the arrangement described in the ruling is not “payable solely on account of the attainment of one or more performance goals,” as required by Section 162(m).
- **Expands the IRS position to include “voluntary retirement.”** Likewise, because retirement generally is a voluntary action within the control of the executive, the compensation covered by the arrangement described in the ruling is not “payable solely on account of the attainment of one or more performance goals,” as required by Section 162(m).
- **Provides transition relief.** The holdings in the ruling will not be applied retroactively. The new positions in the ruling will not apply to otherwise performance-based compensation that is paid under a plan, agreement, or contract with payment terms similar to the terms described in the ruling if either:
 - ♦ the performance period (the period of service to which the performance goal relates) begins on or before January 1, 2009; or
 - ♦ the compensation is paid pursuant to the terms of an employment contract as in effect on February 21, 2008, (without respect to future renewals or extensions, including renewals or extensions that occur automatically absent further action of the parties to the contract).

February 28, 2008

Although not entirely clear under the ruling, a contract that is renewed or is extended (including by automatic extension) after February 21, 2008, will likely no longer be covered by the transition relief. This means that companies must carefully review the expiration and renewal provisions of existing employment agreements for purposes of determining and monitoring the applicable transition period.

Updated Action Plan

Now that the IRS has issued Revenue Ruling 2008-13, companies have additional time to review employment agreements, plans, and contracts to identify payment terms similar to the terms described in the ruling and to determine potential “fixes” for future performance-based compensation. Although the transition relief is helpful, companies need to review and monitor the expiration and renewal provisions of employment agreements to determine the applicable transition period. We encourage you to prepare an action plan in coordination with your advisors. We have included a sample action plan in our February 20, 2008, HRO Alert.

If you have any questions concerning this alert, or compliance with Section 162(m) or other compensation matters, please contact any of the individuals listed on this alert.

This alert 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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