TAX & EMPLOYEE BENEFITS

Legal News Alert[SM]

FOLEY

FOLEY & LARDNER LLP

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Legal News Alert is part of our ongoing commitment to providing up-to-the minute information about pressing concerns or industry issues affecting our tax and employee benefits clients and colleagues.

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IRS Advice Stirs Confusion Regarding Qualified Performance-Based Compensation Under Code Section 162(m)

Section 162(m) of the Internal Revenue Code limits the tax deduction for compensation paid to each covered executive of public corporations to $1,000,000 per year. An exception to this $1,000,000 limitation applies for "qualified performance-based compensation." Qualified performance-based compensation has a number of requirements such as shareholder approval of possible performance goals and objective quantification of those goals in advance. Additionally, Treas. Reg. § 1.162-27(e)(2)(v) provides that an award does not qualify as performance-based compensation if the facts and circumstances indicate the award would be paid out regardless of whether the performance goal is attained. The regulation further provides an award will not fail to be qualified performance-based compensation merely because the plan allows for payments upon death, disability, or a change of control irrespective of satisfaction of the performance goals (though if any such death, disability, or change in control event occurred, the resulting payment itself would not be performance-based compensation).

Previously, the Internal Revenue Service (IRS) has issued private letter rulings indicating that the entitlement to payment of award amounts in the event of termination of the executive without cause or by the executive with good reason were similar to death, disability, and change of control. As a result, the rulings concluded that the existence of such provisions in plans would not taint awards actually made based on the performance goals.

The IRS reached the opposite conclusion in a recent private letter ruling. In PLR 200804004, the IRS concluded that permitting the executive to receive incentive awards upon involuntary termination without cause or by the executive with good reason, regardless of satisfaction of the performance goals, does not meet the exception in Treas. Reg. § 1.162-27(e)(2)(v) described above and taints the entire award. Consequently, such awards cannot be qualified performance-based compensation even if no termination of the employment of the executive occurs.

In a February 14, 2008, conference call with tax practitioners, Kenneth Griffin, Associate Chief Counsel of the IRS' Executive Compensation Branch, stated that the IRS has been considering the many complaints it has received and will be releasing further guidance, hopefully by the end of February. While he was very guarded in his remarks, one possibility is that such guidance will retain the recent IRS conclusion but provide some grandfathering with respect to outstanding awards. His advice to practitioners was "Don't take drastic actions based on the ruling." Instead, companies should wait for the future guidance.

The change in position reflected in the private letter ruling should not impact employment or severance arrangements that apply only following a change of control of the corporation. Those arrangements should continue to fall under the exception for acceleration of payments following a change of control. Instead, the new interpretation applies to employment agreements, severance arrangements, and plan provisions that apply absent a change of control and serve to provide a payment irrespective of the achievement of the performance goal.

In light of these developments, the change in authority may impact the tax reserves and disclosure statements of public companies. Public companies that intend to utilize the qualified performance-based compensation exception under Section 162(m) should consider reviewing plans and employment agreements to determine the potential impact, if any, of various severance arrangements on qualified performance-based compensation as these issues evolve.

Internal Revenue Service regulations generally require that, for purposes of avoiding United States federal tax penalties, a taxpayer may only rely on formal written opinions meeting specific requirements described in those regulations. This newsletter does not meet those requirements. To the extent this newsletter contains written information relating to United States federal tax issues, the written information is not intended or written to be used, and a taxpayer cannot use it, for the purpose of avoiding United States federal tax penalties, and it was not written to support the promotion or marketing of any transaction or matter discussed in the newsletter.

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