

EMPLOYEE BENEFITS & EXECUTIVE COMPENSATION UPDATE

IRS Issues Revenue Ruling on Effect of Severance Provisions on Section 162(m) Performance-Based Compensation Arrangements *February 28, 2008*

As summarized in our Client Alert of February 8, 2008, the IRS issued a private letter ruling (PLR) that reversed its prior position relating to the effect of severance provisions on performance-based compensation arrangements under section 162(m) of the Internal Revenue Code (relating to the \$1 million limit) (see “[IRS Changes Position on Effect of Severance Provisions on Section 162\(m\) Performance-Based Compensation Arrangements](#)”). Of critical concern to many employers was whether the IRS’s new position would be applied to amounts already earned and/or paid under existing compensation arrangements, resulting in the possible disallowance of past deductions and the need, in some cases, to revise past financial statements and/or disclosures to shareholders.

The IRS issued [Revenue Ruling 2008-13](#) on February 21, 2008, addressing the same issue as the PLR regarding the effect of severance provisions on performance-based compensation under section 162(m) but, unlike a PLR, the Revenue Ruling has applicability to all taxpayers. Generally, the Revenue Ruling provides that an

award will not satisfy the requirements for performance-based compensation under section 162(m) if all or part of the compensation may be paid without regard to satisfaction of the performance goals and the facts and circumstances indicate that the compensation would be paid even in the event of poor performance (such as a termination for good reason as a result of a reduction in base salary or title) or as a result of a voluntary termination of employment (such as retirement).

The full impact of the Revenue Ruling is not entirely clear. For example, the PLR indicated that impermissible severance provisions would result in a loss of favorable 162(m) treatment for the entire arrangement (which encompasses not only the specific bonus arrangement but all ancillary agreements that relate to the bonus arrangement or payment of the bonus, such as employment agreements). The Revenue Ruling, however, suggests that the analysis would be applied on a case-by-case basis and may only taint awards to which the impermissible severance provisions apply or may apply only to the executive who

received a tainted award. Further, the IRS left open the possibility that there are facts and circumstances (in addition to those that are set forth in applicable regulations) that would not result in loss of favorable 162(m) treatment for the entire award or arrangement, though it is not clear what those facts and circumstances might be.

Significantly, however, the IRS has made clear that the holdings in the Revenue Ruling will not be applied by the IRS to retroactively disallow deductions for any compensation payable under an arrangement that otherwise satisfies the requirements for performance-based compensation but that contains provisions similar to those described in the fact patterns addressed by the Revenue Ruling. Thus, employers should be relieved of the need to restate their financial information and/or revise disclosure to shareholders with respect to such amounts. As noted below, the Revenue Ruling also provides “grandfather” protection from the new standards in the ruling for compensation that otherwise meets the definition of “performance-based” compensation if either the performance period for the compensation begins on or before January 1, 2009, or the compensation is paid pursuant to the terms of an employment agreement as in effect on February 21, 2008, without regard to future renewals or extensions, including automatic renewals or extensions.

Summary of Revenue Ruling

The Revenue Ruling addresses two fact patterns. The first involves a bonus plan that provides that a cash bonus will be paid to a covered executive on attainment

of the performance goal. The plan also provides that the bonus will be paid, even if the performance goal is not attained, if the executive dies, becomes disabled, is terminated without cause, terminates for good reason or if the employer experiences a change in control. The plan contains specific definitions of “cause” and “good reason.”

The Revenue Ruling notes that applicable Treasury regulations under section 162(m) state that compensation is not performance-based if the facts and circumstances indicate that the employee would have received all or part of the compensation without regard to satisfaction of the performance goal (the “facts and circumstances test”). The Revenue Ruling further notes that applicable regulations specifically provide that compensation under an arrangement will not fail to be treated as performance-based even though amounts may be paid without regard to the satisfaction of the performance goals in the event of death, disability, or change in control. It also correctly states that termination for cause or good reason are not events that are listed in the regulations as permissible payment events.

The Revenue Ruling applies the facts and circumstances test to this fact pattern, holding that because a termination without “cause,” or a termination for “good reason” (such as a reduction in title or base salary), may occur as a result of poor performance and the failure to satisfy the performance goal, the “award” is not performance-based compensation for purposes of section 162(m). It appears that the holding is limited to the specific cash award in question, rather than the entire arrangement.

The second fact pattern is similar to the first except that the plan provides for payment without regard to whether the performance goal was met in the event of death, disability, change in control or on account of an employee's voluntary retirement. Consistent with the analysis described above, the Revenue Ruling holds that a "voluntary retirement" is a voluntary action within the control of the executive, that the compensation may be paid without regard to satisfaction of the performance criteria and, therefore, the "award" is not performance-based compensation for purposes of section 162(m). Again, it appears that the holding is limited to the specific cash award in question and not the entire arrangement.

Note that plans that provide for conditional vesting in all or a portion of an award upon termination of employment under specified circumstances, but still condition the ultimate payout of the award on satisfaction of the performance criteria, should not be affected by the Revenue Ruling. It is less clear whether payment upon termination without cause or for good reason following a change in control will be treated as meeting the provisions of the regulations or the facts and circumstances test.

Application

As noted above, the Revenue Ruling provides that its holdings will not be applied to disallow deductions for any compensation payable under arrangements that otherwise satisfy the requirements for performance-based compensation, but that contain provisions similar to those described in

the fact patterns addressed by the Revenue Ruling, if either (1) the performance period for the compensation begins on or before January 1, 2009, or (2) the compensation is paid pursuant to the terms of an employment agreement as in effect on February 21, 2008 (without regard to future renewals or extensions, including automatic renewals or extensions).

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