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Employee Benefits, Executive Compensation Update
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# Effect of Severance Arrangements on the Performance-Based Compensation Exception to the $1 Million Deduction Limit

US Internal Revenue Service (IRS) Revenue Ruling 2008-13 (the "Ruling"), available at http://www.irs.gov/pub/irs-drop/rr-08-13.pdf, describes an incentive compensation arrangement that was generally intended to provide payment only if certain performance goals were attained, but also provided for payment by reason of an executive's involuntary termination of employment (which included termination by the company without cause and termination by the executive for good reason) or by reason of retirement, in each case without regard to satisfaction of the performance goals.

The Ruling held that the incentive compensation would not satisfy the "performance-based compensation" exemption from the $1 million limit on deductible compensation imposed by Internal Revenue Code section 162(m), even if the compensation was actually paid upon the attainment of the applicable performance goals. The holding reversed the holdings of earlier IRS private letter rulings. We described the effects of the Ruling in our February 28, 2008, Client Update "IRS Issues Revenue Ruling on Effect of Severance Provisions on Section 162(m) Performance-Based Compensation Arrangements," available at http://www.mayerbrown.com/publications/article.asp?id=4261&nid=6.

## End of Transition Period

The Ruling provides for a transition period during which its holding will not be applied to disallow deductions for 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 Ruling. This transition period applies *only to* compensation paid pursuant to the following arrangements: (i) arrangements for which the performance period for the compensation begins on or before January 1, 2009, and (ii) employment agreements as in effect on February 21, 2008, without regard to future renewals or extensions, including automatic renewals or extensions.

Companies that are establishing new compensation arrangements as of January 1, 2010 (or later) may want to review the design of their arrangements to determine whether changes can and should be made to the arrangements to satisfy the requirements in the Ruling. It is important to note, however, that a company may need to obtain an executive's consent before making changes to the executive's employment agreement or other individual arrangement.

## Application of Ruling to Severance Arrangements

The Ruling does not discuss the factors that may be relevant in determining whether or not severance benefits will be treated as causing a performance-based compensation arrangement to fail to satisfy the requirements of section 162(m) of the Internal Revenue Code, and the IRS has not issued formal guidance addressing this issue. However, senior IRS representatives, in panels and seminars, have informally discussed the Ruling and the foregoing issue (always with the caveat that their comments do not necessarily reflect the position of the IRS). We believe that their comments suggest that the rationale used by the compensation committee of the board of directors to establish the amount of the severance might be important. Although not directly addressed by the IRS representatives, it appears that evidence of the

compensation committee's rationale might include the information regarding the severance payments that was provided to the committee by its compensation consultant, as well as the minutes of the meeting at which the severance amounts were established.

The terms of a severance program might also be viewed as indicative of the rationale used by the compensation committee. The following summarizes approaches that are sometimes used to determine the amount of severance to be paid on an involuntary termination, with suggestions as to how we believe they each might be analyzed for purposes of determining whether it would be treated as payments made under a bonus plan without regard to whether the performance goal is attained (referred to below as a "substitute payment") and, therefore, problematic under section 162(m).

For purposes of these examples, assume that (i) a company maintains an annual bonus plan that is intended to satisfy the performance-based compensation requirements, and (ii) an executive participating in the plan is a party to an employment agreement (or other arrangement) providing for severance payments if the executive's employment is terminated without cause or if the executive resigns for good reason.

- **Target Bonus in Termination Year.** The executive will receive no bonus for the year of termination, but the employment agreement expressly states that the severance amount will equal 100 percent of salary plus 100 percent of the target bonus for the year of termination. Comments from IRS representatives suggest that this structure might be viewed as reflecting an intent to provide a substitute payment.
- **Increased Salary Multiple for Severance.** An executive will receive no bonus for the year of termination, but the employment agreement provides severance equal to 200 percent of salary. The employment agreement does not expressly provide that severance will include the bonus amount for the year, but the executive's target bonus is 100 percent of salary. If the foregoing provisions apply to only one officer, the arrangement does not appear to offer strong evidence as to whether or not the arrangement should be treated as providing a substitute payment. However, if severance for all of the top executives is 200 percent of salary, but the target bonus amounts for those top executives, expressed as a percentage of salary, varies depending on the executive's position, the provisions would appear to suggest that the arrangement does not provide a substitute payment.
- **Payments Over Remaining Agreement Term.** The executive will receive no bonus for the year of termination, but the employment agreement provides severance equal to salary and target bonus for the remainder of the employment agreement term. It seems possible that the IRS would view this arrangement as providing a form of liquidated damages as a result of the company having prevented the executive from remaining employed for the agreed-upon employment term, rather than being treated as providing a substitute payment.
- **Average Bonuses.** The executive will receive no bonus for the year of termination, but the employment agreement provides severance equal to the average of the bonuses actually paid for the two years prior to the year of termination. Because, under this arrangement, the amount of the severance payment is not based on amounts otherwise due for the year of termination, and because the amount of the prior years' bonuses would likely be higher or lower than the amount that otherwise would have been payable for the year of termination, it appears that this arrangement should not be viewed as providing a substitute payment.
- **Earned Bonus for Year of Termination Plus Target Bonus.** The executive will receive a bonus for the year of termination, but only to the extent that the bonus would have been earned by reason of actual achievement of a preestablished performance goal for the entire performance period. (The bonus based on actual performance might, but need not be, subject to a *pro rata* reduction to reflect the portion of the performance period after termination.) In addition, the executive will receive a severance payment equal to 100 percent of salary plus 100 percent of the

target bonus for the year of termination. Informal comments by IRS representatives suggest that this approach might avoid the concern covered by the Ruling because it involves a separate payment that takes into account the actual performance for the year of termination. As a result, the severance payment would be considered an additional severance payment and not a substitute payment for the year.

*If you would like more information about the foregoing, please contact any member of our Employee Benefits and Executive Compensation practices or the authors of this Client Update, Wayne R. Luepker and Debra B. Hoffman.*

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