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Employee Benefits Advisory: Section 162(m)

Where Do We Go from Here?

5/7/2008

Introduction[1]

Section 162(a) of the Internal Revenue Code of 1986, as amended (the "Code"), permits a business to deduct all the "ordinary and necessary" expenses associated with operating the business during the taxable year, including reasonable compensation for its employees (*e.g.*, salaries, bonuses, and health benefits). Nonetheless, Code Section 162(m)(1) prohibits publicly held corporations from taking a deduction for amounts paid to "covered employees" in excess of $1,000,000. Covered employees are determined as of the last day of the taxable year and include the chief executive officer of the corporation and the three highest paid officers whose compensation must be reported to shareholders under the Securities Exchange Act of 1934.[2]

Code Section 162(m)(4)(c), however, exempts "performance-based" compensation from the $1,000,000 deduction limitation. In order to qualify as performance-based under Code Section 162(m)(4)(c), compensation must be payable only upon the achievement of one or more preestablished objective performance goals established by a compensation committee consisting solely of two or more outside directors. Code Section 162(m)(4)(c) also requires that the material terms of the performance goals be disclosed to and approved by a majority of the corporation's shareholders. In addition, the compensation committee must certify the achievement of such goals before payment can be made.

Compensation that may be paid regardless of whether the performance goals are achieved is not performance-based and will not qualify for the exemption even if the goals are achieved from year-to-year. For example, if a bonus plan sets forth certain performance criteria for determining bonuses but the compensation committee retains discretion to pay such bonuses even if the criteria are not met, the plan and any bonuses paid under it will not meet the requirements of Code Section 162(m).

One notable exception to the general rule discussed above is set forth in Treasury Regulation § 1.162-27(e)(v). Treasury Regulation § 1.162-27(e)(v) provides that a plan (or related agreement) may provide that payment may be made upon death, disability, or change in control regardless of whether the goals are achieved. Although payments made prior to the achievement of established goals will **still not qualify** for the exemption from the $1,000,000 deduction limit, payments can be made upon these events without causing the whole plan (including related agreements) to lose its performance-based status.

Private Letter Rulings

Subsequent to the issuance of the final Treasury Regulations under Code Section 162(m) in December 1995, the Internal Revenue Service seemingly expanded the payment exception for death, disability, and change in control to include involuntary termination without cause or termination for good reason when it issued Private Letter Ruling (PLR) 199949014, which approved an arrangement containing such terms. The IRS reaffirmed its position when it issued PLR 200613012, which expanded the exception even further to the payment of a bonus upon retirement. Procedurally, only the taxpayer to whom a PLR is issued may rely upon the ruling; however, counsel and employers often look to PLRs for guidance on how the IRS would rule in similar cases. Despite the known procedural limitations, it is a generally accepted practice to rely upon PLRs in designing programs and tax strategies.

The IRS signaled a dramatic reversal of its position in PLRs 199949014 and 200613012 when it issued PLR 200804004, which held that performance share based compensation payable to an executive upon a termination without cause or for good reason is not performance based for Code Section 162(m) purposes. Notably, the offending payment terms were contained in an employment agreement and not in the actual performance share plan.

The issuance of PLR 200804004 greatly alarmed the legal community and affected employers who relied on the pre-2008 PLRs in designing their respective 162(m) plans. Tax and executive compensation attorneys throughout the country requested the IRS to reconsider its position, but the IRS made clear it had no intention of withdrawing its 2008 ruling.

Revenue Ruling 2008-13

Despite the outcry from the legal community and corporations alike, the IRS issued Revenue Ruling 2008-13 ("2008-13"), which reaffirmed the IRS's position that arrangements allowing for payment upon termination without cause, termination for good reason, or retirement are not performance-based arrangements under 162(m) and that the $1,000,000 cap on deductions is applicable to such compensation. Both PLR 200804004 and 2008-13 make clear that all agreements (including employment and severance agreements) potentially affecting payment must be read together with incentive plans for compliance with 162(m).

Fortunately, the IRS did provide some transition relief in 2008-13 by providing that the ruling is prospective and that it will not be applied to disqualify deductions to otherwise compliant arrangements that contain termination without cause, for good reason, or retirement payment triggers. In order to qualify for the relief in 2008-13, the applicable compensation must either relate to a performance period beginning on or before January 1, 2009, or be paid pursuant to an employment agreement in effect on February 21, 2008. If an employment agreement is extended or renewed after February 21, 2008, it does not qualify for the relief under 2008-13.

Conclusion

2008-13 makes clear that just the possibility that compensation may be paid upon termination without cause, for good reason, or retirement causes such compensation and the plan containing such terms to lose its performance-based status under Code Section 162(m), regardless of whether these provisions are ever triggered.[3] Although members of the tax and executive compensation bars will continue pressing the IRS to withdraw the 2008 PLR, it seems unlikely further relief will be provided. In light of the current situation, all publicly held corporations intending to take advantage of the 162(m) exception to the $1,000,000 deduction limitation should conduct a review of its current "performance-based" arrangements and related agreements with covered employees to ensure compliance. Changes may require negotiations with the affected individuals, and since the relief provided in 2008-13 could be ending as soon as January 1, 2009, companies should not hesitate in addressing this issue. The Code Section 162(m) review can be coordinated with a Code Section 409A review since the 409A compliance transition period ends on December 31, 2008. We will keep you apprised of further changes in this important area.

Endnotes

[1] Please note that this article is not intended as a comprehensive discussion of Code Section 162(m) and should not be relied upon as such. The background is provided as context for the discussion in the "Private Letter Rulings" and "Revenue Ruling 2008-13" Sections of this article.

[2] The '34 Act disclosure rules and Code Section 162(m) are not consistent with respect to which individuals are covered employees under 162(m) and which executives are covered by the disclosure rules. The IRS issued Notice 2007-49 to resolve this ambiguity. Notice 2007-49, which is inconsistent with the statutory language of 162(m), excludes the chief financial officer from coverage under 162(m).

[3] The acceleration of vesting on option grants that are otherwise performance-based under Code Section 162(m) is not affected by 2008-13.

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If you have any questions concerning the information discussed in this alert or any other employee benefits topic, please contact one of the attorneys listed below or your primary contact with the firm who can direct you to the right person. We would be delighted to work with you.

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