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Recent IRS Ruling under Internal Revenue Code Section 162(m) May Adversely Affect Incentive Awards and Arrangements

On January 25, 2008, the Internal Revenue Service ("IRS") released a private letter ruling[1] holding that a provision in a performance share or performance unit award allowing payment to be made in the event of termination of the employee's employment by the employer without cause or by the employee for good reason without attaining the performance goal would preclude the award from qualifying for the performance-based compensation exception to the $1 million cap on deductible compensation under Section 162(m) of the Internal Revenue Code of 1986, as amended (the "Code"). This holding differs from the position taken by the IRS in private letter rulings issued in 1999 and 2006 and, if it represents a correct interpretation of the applicable tax rules, would adversely affect numerous incentive awards and arrangements.

The new private letter ruling relates to performance share and performance unit awards issued by a publicly held corporation intended to be performance-based compensation under Section 162(m)(4)(C) of the Code. The corporation entered into an employment agreement with an executive entitled to receive grants of such performance shares and performance unit awards. Pursuant to such employment agreement, if the executive's employment were terminated by the corporation without "cause" (as defined in the employment agreement) or by the executive for "good reason" (as defined in the employment agreement), the performance goals under any outstanding performance share and performance unit awards would be treated as having been achieved at target and the awards would vest at termination of employment to the extent they would have vested if the executive had continued in employment for an additional two years.

Section 162(m) of the Code generally disallows a deduction for compensation paid by a publicly held corporation during any taxable year to the corporation's principal executive officer or any of the three most highly compensated officers (other than the principal executive officer or the principal financial officer) to the extent the amount of such compensation for the taxable year exceeds $1 million.[2]

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[1] PLR 200804004.

[2] Under IRS guidance based on certain technical considerations, the principal financial officer is no longer one of the employees covered by Section 162(m) of the Code. Future legislation may change this treat-

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However, there is an exception for "performance-based" compensation described in Section 162(m)(4)(C) of the Code. Under the regulations, one of the requirements for compensation to qualify as "performance-based" for this purpose is that the compensation must be paid "solely on account of the attainment of one or more preestablished, objective performance goals."[3] The regulations go on to provide that compensation does not fail to be considered "performance-based" merely because the plan allows the compensation to be payable upon death, disability, or change of ownership or control, although compensation actually paid on account of those events prior to the attainment of the performance goal would not qualify as "performance-based" compensation.[4]

In the new private letter ruling, the IRS concluded that the provision in the employment agreement allowing for payment of the performance share or performance unit awards upon termination of the executive's employment by the corporation without cause or by the executive for good reason without attaining the performance goal would preclude the awards from meeting the "performance-based" compensation exception because the compensation would not be payable solely on account of attainment of a performance goal. This would be true even if in fact the executive's employment did not terminate prior to the end of the performance period and the executive earned the award by reason of meeting the performance goal. This conclusion represents a change of position from that taken by the IRS in private letter rulings issued in 1999 and 2006[5] which treated a provision allowing payment upon termination of employment by the employer without cause or by the employee for good reason as similar to payment upon death, disability or change of control and, therefore, not precluding qualification of the award as "performance-based" compensation for purposes of Section 162(m) of the Code.

A private letter ruling applies only to the taxpayer who requested that ruling. It does not apply to, and cannot be relied upon by, other taxpayers. However, private letter rulings may reflect the position of the IRS on the applicable issues. Thus, the new private letter ruling suggests that there has been a change in the IRS's position. We understand that the new private letter ruling received a high level of review at the IRS.

Many employers have designed their incentive plans and awards on the basis of the interpretation represented by the prior private letter rulings. If the position reflected in the recent private letter ruling represents the correct interpretation of the law, many existing awards that were intended to meet the "performance-based" compensation exception would in fact be subject to the $1 million cap on deductible compensation. Moreover, if this position were given retroactive effect, it might affect substantial deductions taken by employers in prior years. It could also impact public disclosures in proxy statements and other documents and have adverse financial accounting ramifications. Employers should review their outstanding incentive awards intended to qualify as "performance-based" compensation under Section 162(m) of the Code and consider the terms of any such new incentive awards in light of the recent private letter ruling. Even under the position reflected in the recent private letter ruling, there should not be a problem if the award provided that, upon an involuntary termination without cause or a termination for good reason, the employee would be entitled at the end of the performance period to a pro rata portion of

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3 Treas. Reg. Section 1.162-27(e)(2)(i).

4 Treas. Reg. Section 1.162-27(e)(2)(v).

5 PLR 199949014 and PLR 200613012, respectively.

the award actually earned based on the level of attainment of the performance goals. Because the recent private letter ruling has generated significant controversy in the employee benefits community and would have far-reaching ramifications, we expect that the IRS will have more to say on this issue. During a webcast presentation on February 14, 2008, Kenneth M. Griffin, the IRS reviewer who signed the recent private letter ruling, indicated that the IRS would be issuing public guidance on this issue in the near future, possibly as early as the end of February, 2008. As a result, employers should wait until this guidance is issued before making any changes to existing plans or agreements.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to contact Michael Macris at (212) 701-3409 or mmacris@cahill.com; Glenn Waldrip at (212) 701-3110 or gwaldrip@cahill.com.

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