

CAHILL GORDON & REINDEL LLP
EIGHTY PINE STREET
NEW YORK, NEW YORK 10005-1702
TELEPHONE: (212) 701-3000
FACSIMILE: (212) 269-5420

February 26, 2008

This memorandum is for general information purposes only and is not intended to advertise our services, solicit clients or represent our legal advice as to any particular set of facts, nor does this memorandum represent any undertaking to keep recipients advised as to all relevant legal developments.

IRS Revenue Ruling under Internal Revenue Code Section 162(m)
Upholds Private Letter Ruling but Grants Transition Relief

On February 21, 2008, the Internal Revenue Service (“IRS”) issued a revenue ruling¹ upholding the position it had taken in a private letter ruling² released on January 25, 2008 relating to 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”). Under this revenue ruling, compensation would not be considered “performance-based” for purposes of Section 162(m) of the Code if the plan or agreement under which the compensation is paid provides that the compensation will be paid without regard to whether the performance goal is attained in either of the following situations: (i) the employee’s employment is involuntarily terminated by the employer without cause or the employee terminates his or her employment for good reason, or (ii) the employee retires. This holding differs from the position taken by the IRS in two earlier private letter rulings.³ While a private letter ruling applies only to the taxpayer who requested that ruling, a revenue ruling has general applicability. In recognition of the fact that many employers have designed their plans and agreements in light of the position taken by the IRS in the earlier private letter rulings, the new revenue ruling contains broad transition relief (described on the last page of this memorandum).

The new revenue ruling relates to a bonus plan maintained by a publicly held corporation pursuant to which a cash award would be paid to a covered employee if a performance goal is met. The plan also provided that, even if the performance goal were not met, the award would be paid if the employee dies or becomes disabled, or if the employer experiences a change of ownership or control. The revenue ruling addresses two additional situations in which the plan would pay the award even if the performance goal were not attained. In the first situation, the award would be paid even if the performance goal were not attained if the employee is terminated by the employer without “cause” (as defined in the plan) or if the employee terminates his or her employment for “good reason” (as defined in the plan). In

¹ Revenue Ruling 2008-13.

² Private Letter Ruling 200804004. This private letter ruling was discussed in a memorandum prepared by this Firm dated February 14, 2008.

³ Private Letter Rulings 199949014 and 200613012.

the second situation, the award would be paid even if the performance goal were not attained if the employee voluntarily retired. The IRS held in this revenue ruling that, in each of these situations, the award would not meet the “performance-based” compensation exception under Section 162(m)(4)(C) of the Code (even if the employee in fact remained in employment through the end of the performance period and received the award by reason of the attainment of the performance goal).

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.⁴ 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.”⁵ 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.⁶

In the new revenue ruling, the IRS concluded that a provision in the plan allowing for payment of the award upon 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 meeting the “performance-based” compensation exception because the compensation would not be payable solely on account of attainment of one or more performance goals. The IRS noted that an involuntary termination without cause or a termination of employment for good reason might result from the employee’s poor performance and failure to meet the performance goal. Similarly, the IRS concluded that a provision in the plan allowing for payment upon a voluntary retirement without attaining the performance goal would mean that the compensation would not be payable solely on account of attainment of one or more performance goals and would, therefore, preclude the award from meeting the “performance-based” compensation exception. The IRS noted that retirement generally is a voluntary action within the control of the employee.

The new revenue ruling would not preclude an award from meeting the “performance-based” compensation exception if the compensation is payable without meeting the performance goal in the narrow circumstances set forth in the regulations: death, disability or a change of ownership or control of the employer. The new revenue ruling also would not preclude an award from meeting the “performance-based” compensation exception if the award provides for payment at the end of the performance period of a pro rata portion of the award actually earned based on the level of attainment of the performance goal or goals.

⁴ 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 treatment.

⁵ Treas. Reg. Section 1.162-27(e)(2)(i).

⁶ Treas. Reg. Section 1.162-27(e)(2)(v).

The new revenue ruling does contain broad transition relief. Under this relief, the holdings of the revenue ruling will not be applied to disallow a deduction for any compensation that otherwise would satisfy the “performance-based” compensation exception under Section 162(m)(4)(C) of the Code and the related regulations and that is paid under a plan, agreement or contract with payment terms similar to those described in the revenue ruling if either (i) the performance period for the compensation begins on or before January 1, 2009 or (ii) the compensation is paid pursuant to the terms of an employment contract as in effect (without regard to future renewals or extensions, including renewals or extensions that occur automatically absent action of the one of the parties) on February 21, 2008. As a result of this transition relief, it should not be necessary to modify outstanding awards or to take immediate action to modify existing plans and agreements to conform to the new IRS position.

In designing plans, agreements and awards intended to comply with the “performance-based” compensation exception under Section 162(m) of the Code, employers should seek to comply with the holdings in this new revenue ruling to the extent the transition relief is not applicable.

* * *

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.

* * *

IRS Circular 230 disclosure: To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this document is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter that is contained in this document.