

NEW IRS RULING IMPACTS COMPENSATION OF PUBLIC COMPANY EXECUTIVES

On February 21, 2008, the IRS issued Revenue Ruling 2008-13, which limits the scope of the performance-based compensation exception to Internal Revenue Code Section 162(m). Code Section 162(m) limits the deductibility of certain compensatory payments in excess of \$1,000,000, but certain performance-based compensation is exempt from these limits as described below. As a result of this ruling, the exception will be applied more narrowly.

Based on prior IRS guidance, many public companies have taken the position that bonuses or incentive compensation can qualify as "performance-based compensation" under Section 162(m) if the amounts are payable in connection with an executive's termination of employment without "cause" or for "good reason," regardless of whether the performance goals have been satisfied. The payment of these bonuses may be made pursuant to an executive employment agreement, a bonus plan, or award agreements. However, as a result of Revenue Ruling 2008-13, such provisions may cause a company to lose its tax deduction for every year, *even if no termination actually occurs*.

Code Section 162(m) provides that a public company generally cannot deduct more than \$1,000,000 in annual compensation paid to its CEO and the three highest compensated officers, other than the CEO and principal financial officer. However, "performance-based compensation" is not counted against the \$1,000,000 limit. Performance-based compensation generally is compensation paid solely upon achievement of one or more shareholder-approved performance goals. In 1999 and 2006, the IRS released private letter rulings which provided that incentive compensation will not fail to be "performance-based compensation" solely because it also is payable if the covered employee is terminated without cause, voluntarily terminates for good reason or retires.

The IRS took a contrary position in a controversial private letter ruling issued in late January, thereby calling into question deductions that many companies have taken in prior years as well as the deductibility of amounts payable in the future under arrangements currently in place. In response to public pressure for clarification, the IRS issued Revenue Ruling 2008-13. This Ruling marks an official reversal of the IRS position on this issue, but provides important transitional relief.

The Revenue Ruling provides that the IRS will not retroactively apply its new position and challenge deductions taken in prior years based on earlier IRS private letter rulings. The IRS will grandfather performance-based compensation arrangements if the period of service for which the performance goals relate begins on before January 1, 2009, or if the compensation is paid pursuant to the terms of an employment contract that was in effect on February 21, 2008, but only to the extent of its current term and not with respect to any renewals or extensions, including automatic renewals contained in the employment agreement.

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What to do now

Public companies should review all incentive plans, arrangements and agreements that may be affected by the Revenue Ruling, and to the extent necessary, they should be revised.

If changes are required to be made in order for the "performance-based compensation" exception to apply in light of the Revenue Ruling, a determination should be made as to the best approach. For example, the arrangement can be amended to provide that, following a termination of employment without cause or for good reason, bonuses or other awards intended to qualify as performance-based compensation are paid (or performance-based restricted stock becomes vested) only if the performance targets are actually achieved in the relevant performance period. This approach would eliminate the possibility that the payments would be made in a year when performance targets are not met. Alternatively, in certain circumstances, it may be permissible to pay out partial bonuses based on the achievement of performance targets through the date of the employee's termination.

Since many employment agreements and other benefit plans need to be revised by December 31, 2008 to comply with the rules applicable to deferred compensation under Code Section 409A, the Code Section 162(m) review can be performed in conjunction with this review.

The summary set forth herein is intended to be general in nature and does not constitute legal advice with respect to any particular situation. No legal or business decision should be based solely on its contents.

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