

Feb 26 2008 Nixon Peabody: IRS ruling requires review of public company incentive compensation plans and executive employment agreements

Section 162(m) of the Internal Revenue Code denies a tax deduction to public companies for compensation in excess of \$1 million paid to certain officers, unless the compensation meets specific performance-based standards and procedures. In a reversal of position, the IRS has issued a ruling that will require all public companies to review their incentive compensation plans and executive employment agreements to maintain qualification under Section 162(m).

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In a reversal of position, the IRS has issued a revenue ruling that will require all public companies to review their incentive compensation plans and executive employment agreements to maintain qualification under Section 162(m) of the Internal Revenue Code.

Section 162(m) denies a tax deduction to public companies for compensation in excess of \$1 million paid to certain officers, unless the compensation meets specific performance-based standards and procedures. The standards require that the compensation be paid "solely" on the account of attainment of performance goals. Procedurally, the performance goals must be determined by an outside compensation committee, the material terms of the plan must be approved by shareholders, and before any payment of such incentive compensation is made, the compensation committee must certify that the performance goals and other material terms were in fact satisfied. The officers to which Section 162(m) applies include the chief executive officer and the four most highly compensated officers (other than the CEO) whose compensation must be disclosed to shareholders under SEC reporting rules.

Section 162(m) performance plans, or employment agreements for the designated officers, often contain special provisions for the payment of an officer's "target" incentive bonus upon retirement, termination by the company without cause, or resignation by the officer "for good reason." In Revenue Ruling 2008-13, the IRS has declared that if an incentive bonus is payable upon one of these events based on target performance, without regard to actual performance, then all payments to the officer under the plan fail to qualify under Section 162(m), *regardless* of whether the events have occurred. Thus, the company would lose a deduction for compensation in excess of \$1 million paid even if the officer has not retired, been involuntarily terminated, or resigned for good reason.

This Revenue Ruling is contrary to certain private letter rulings issued by the IRS in the past several years under Section 162(m). The solution in general is to replace the provision for payment of the incentive compensation based on target bonus with a provision for paying the bonus (or prorated portion of it) only to the extent the performance goals under the plan are actually attained.

Realizing the accounting and financial reporting effects that the loss of deduction under 162(m) can have on a public company, the IRS has made Revenue Ruling 2008-13 effective prospectively only.

In particular, the IRS will not apply the holding to disallow a deduction for any compensation that otherwise satisfies Section 162(m) if either (i) the performance period for such 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 respect to future renewals or extensions, including renewals or extensions that occur automatically absent further action of one or more parties to the contract) on February 21, 2008. For calendar-based performance periods, this means that the plan or employment agreements do not have to be changed for either 2008 or 2009. However, because many plans operate on fiscal years and many employment agreements renew automatically on an anniversary of employment, it is essential for public companies to review their 162(m) incentive compensation plans and their individual employment agreements for reporting officers. If a provision allows for payment of incentive compensation without regard to attainment of a performance goal (other than due to death or disability), the provision must be amended in order to avoid potentially significant adverse tax effects to the company.

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