IRS Clarifies New Adverse Position on Section 162(m)
Performance-Based Compensation Exception and Provides Transition Relief

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The IRS recently issued Revenue Ruling 2008-13, which clarifies the IRS's new position with respect to the applicability of the performance-based compensation exception for purposes of Section 162(m) of the Internal Revenue Code and grants transition relief to provide public companies an opportunity to review outstanding compensation plans, agreements and other arrangements in light of the IRS's new position.

This update provides general background information on Section 162(m), summarizes the key highlights from Revenue Ruling 2008-13 and offers practical guidance.

General Background on Section 162(m)

Section 162(m) generally limits a publicly held company's ability to deduct applicable compensation with respect to any "covered employee" to the extent that the amount of that employee's compensation for the taxable year exceeds $1 million, subject to certain exceptions, including an exception for performance-based compensation. For more information on identifying "covered employees" for purposes of Section 162(m), see our June 7, 2007 update, IRS Narrows Definition of "Covered Employees" for Purposes of the $1 Million Limitation on Deducting Executive Compensation.

Effect of Revenue Ruling 2008-13

Compensation Payable on Termination of Employment or Retirement Is Subject to Section 162(m) Limitation on Deductibility. Revenue Ruling 2008-13 reverses the IRS's prior position in private letter rulings and provides that compensation will not qualify as performance-based compensation under Section 162(m) if a plan, agreement or other arrangement provides that the compensation will be paid, without regard to whether the applicable performance goal is attained, in the event that

- the executive's employment is involuntarily terminated by the company without cause,
- the executive terminates his or her employment for good reason, or
- the executive retires.

Provides Limited Transition Relief for Existing Compensation Arrangements. Revenue Ruling 2008-13 provides that its holdings will not be applied to disallow a deduction for any compensation that otherwise qualifies as performance-based compensation under Section 162(m) and that is paid under a plan, agreement or other arrangement that has payment terms similar to the terms described in the ruling if either of the following applies:

- The performance period (i.e., the service period to which the performance goal relates) for such compensation begins on or before January 1, 2009; or
- The compensation is paid pursuant to the terms of a contract as in effect (without regard to any future renewals or extensions, including renewals or extensions that occur automatically) on February 21, 2008.
Start Now! Public Companies Should Review Incentive Compensation Arrangements in Light of the IRS's New Position. Public companies should take steps to determine whether any amendments may be required to new and outstanding compensation plans, agreements and other arrangements in light of Revenue Ruling 2008-13. Public companies should identify all new and outstanding compensation plans, agreements and other arrangements involving their “covered employees” (within the meaning of Section 162(m)), with a particular focus on identifying whether these arrangements include termination of employment or retirement as a permitted payment event, and determine whether any amendments may be required in light of Revenue Ruling 2008-13. Common types of plans, agreements and arrangements that may be affected by Revenue Ruling 2008-13 include the following:

- Employment Agreements
- Annual and Multiyear Bonus Plans
- Incentive Compensation Plans
- Equity Awards
- Severance Plans and Agreements
- Change-of-Control Plans and Agreements
- Other Compensation Arrangements

Potential Exception for Stock Options and SARs. Because a special rule in the applicable IRS regulations under Section 162(m) deems some stock options and stock appreciation rights to be performance-based, these stock options and SARs should not be affected by Revenue Ruling 2008-13. Nonetheless, public companies should continue to monitor the status of stock options and SARs in response to the IRS's new position.

Consider Amending Compensation Arrangements. Public companies should consider amending their compensation arrangements in response to Revenue Ruling 2008-13. Public companies should also consider whether to make any adjustments to their governance and public disclosure planning in connection with these amendments. In particular, management should make this determination as soon as possible to facilitate addressing amendments to new and outstanding compensation plans, agreements and other arrangements at upcoming meetings of boards of directors, committees and other governing bodies. Management should also keep in mind all applicable shareholder approval and reporting and disclosure obligations, including for current and periodic reports (Forms 8-K, 10-Q and 10-K) and in proxy statements.

Additional Information


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