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Client Alert

Your Company's Performance-Based Compensation Might Not Be Deductible*

**And Your Executives Might Not Be Able to Defer It*

A Recent IRS Private Letter Ruling Denied a Company's Ability to Exempt Performance-Based Compensation from Section 162(m)'s $1 Million Limit when It could be Paid in Full at Target as a Result of an Employment Contract's Termination Provisions

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On January 25th, the IRS issued a Private Letter Ruling (PLR 200804004) that addressed the treatment of compensation paid under an incentive plan (Plan) that was intended to qualify as "performance-based compensation" under Code Section 162(m) given the termination provisions of an Employment Agreement the Company had entered into with an Executive.

The Facts

The facts detailed in PLR 200804004 that led the IRS to conclude that the Company could not treat bonuses paid as "qualified performance-based compensation" under Code Section 162(m) are as follows:

- Company had a Plan that allowed for the grant of awards that ordinarily would be "qualified performance-based compensation" for purposes of Code Section 162(m), *i.e.*, shareholder approved plan that allowed the grant of performance shares and performance unit awards that utilized performance criteria detailed in the plan.
- Company entered into an Employment Agreement with an Executive who would be covered by Code Section 162(m).
- The Employment Agreement stated that if the Executive was terminated by the Company other than for cause or by the Executive for good reason, any performance goal under any outstanding performance share or performance unit awards would be deemed to be achieved at target and the award would vest and be paid if it otherwise would have vested in accordance with the regular vesting schedule during the two years following termination.

The IRS Analysis

The IRS looked to the Code Section 162(m) regulations which state that "qualified performance-based compensation" must be paid ***solely*** on account of the attainment of one or more pre-established, objective performance goals. Another provision in the regulations indicates that compensation does ***not satisfy*** the ***performance goal requirement if*** the facts and circumstances indicate that the ***employee would receive all or part of the compensation regardless of whether the performance goal is attained.*** The regulations further provide that compensation ***does not fail to be "qualified performance-based compensation" 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 satisfy the performance goal requirement.

Looking at the facts, the IRS concluded that the performance shares and performance units, even though granted in a manner that otherwise would have made them "qualified performance-based compensation" for purposes of Section 162(m), did not qualify as performance-based compensation for the Executive covered by the Employment Agreement because the compensation would ***not*** be ***payable solely upon attainment of a performance goal,*** because the performance shares and performance units would be paid out at target upon the Executive's termination of employment. Consequently, the performance shares and performance units paid to the Executive did not qualify for exemption from Section 162(m)'s $1 million limitation on the deductibility of compensation paid to Covered Employees. Therefore, to the extent the Executive is a Covered Employee and receives non-Section 162(m) qualified compensation that exceeds $1 million, including the performance shares and performance units, the Company will not be permitted to take a tax deduction for the amount of such compensation paid in excess of $1 million.

Implications

Private Letter Rulings are applicable only to the specific company to which they are issued. However, given typical practice regarding how bonuses are addressed in employment agreements, non-CIC severance agreements, plan documents and/or award agreements, companies may be impacted if the IRS decides to apply the approach taken in PLR 200804004 when conducting an audit.

Additionally, the underlying theory which disqualifies the bonus compensation as "performance-based compensation" for purposes of Section 162(m), could ostensibly be applied to "performance-based compensation" in the context of Section 409A (*there have been some suggestions that the implications for Section 409A were the true motivation for the issuance of this Private Letter Ruling*). In such case, executives with employment agreements, non-change in control (CIC) severance agreements and/or plans/award agreements with termination provisions similar to those in PLR 200804004 may not be able to make deferral elections up to 6 months prior to the end of the performance period (because the compensation would not be "performance-based compensation" for purposes of Section 409A). Instead, such executives would have to make their deferral elections in accordance with the other Section 409A timing requirements, *i.e.,* prior to the start of the year in which the performance period commences.

Practical Advice

- Review any employment and/or non-CIC severance agreements and Section 162(m)-qualified plans and award agreements to determine if they would permit the payment of performance-based compensation under an otherwise Section 162(m)-qualified plan at target (or other level not based on actual performance) upon termination of employment[1].
- If any agreement or plan contains such language, consider amending it so that the performance-based compensation will be paid out based upon actual performance achieved for terminations other than those permitted under the Section 162(m) regulations, *i.e.,* death, disability and CIC. Payments based on target amounts could remain for payments triggered by death, disability or CIC.
- Determine whether any of your Section 162(m)-qualified plans have been tainted to such an extent by employment termination provisions similar to those in PLR 200804004 that new plans should be adopted.

[1] In our experience, a significant majority of companies pay bonuses or calculate the bonus to be paid upon a non-CIC severance using the target bonus amount, which would run afoul of PLR 200804004.

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- Consider the possible implications of such language for ostensibly "performance-based compensation" under Section 409A, especially in regard to the timing of deferral elections related to such compensation, *i.e.* determine ***when*** deferral elections must be made.
- Consider what, if any, implications there might be for your company's proxy disclosures, especially those related to performance-based compensation.
- Finally, consider if there are any tax accounting implications for your outstanding performance-based awards as a result of the theory underlying PLR 200804004's holding.

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