



# Executive Compensation Law

**ALERT**  
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## Performance-Based Uncertainty Under IRC Section 162(m)

For federal income tax purposes, Section 162(m) of the Internal Revenue Code precludes a public company from deducting for any year remuneration paid in excess of \$1 million to a “covered employee” (a person who on the last day of the year is the company’s principal executive officer or any of its 3 highest compensated employees other than its principal executive officer or principal financial officer). A primary exception is that, to the extent the remuneration constitutes “performance-based compensation” (compensation paid based upon satisfying pre-established objective performance goals), such compensation will nonetheless be deductible. Generally, performance-based compensation can be paid only upon satisfaction of the applicable performance goals. On the other hand, if the facts and circumstances indicate that all or a portion of the compensation will be paid where the goals are not met, no portion of the performance-based consideration qualifies for the exception.

The regulations under Section 162(m) do permit arrangements to provide for payment to be made where the performance goal has not been met (although the payment will not constitute “performance-based compensation”), in connection with the individual’s death or disability or a change of control of the company. In a 1999 private letter ruling (PLR 199949014), the IRS expanded this concept, concluding that a termination of an individual’s employment by the company without “cause” or by the individual with “good reason” were involuntary terminations similar to terminations resulting from death, disability or a change in control, and that the presence of these terms did not preclude the payments from constituting performance-based compensa-

tion for purposes of Section 162(m). In a 2006 private letter ruling (PLR 200613012), the IRS further expanded this to include the individual’s retirement.

However, in a recently-released private letter ruling (PLR 200804004), the IRS has taken a new hard-line position, that affects public companies having employment or other incentive compensation arrangements or plans that provide, fairly typically, for full vesting and/or payments at “target” levels should the individual’s employment be terminated without cause or should the individual resign with good reason. In Private Letter Ruling 200804004, the IRS concluded that the mere possibility of vesting or payment upon termination without cause or resignation for good reason taints the arrangement, rendering all compensation payable thereunder as ineligible for the “performance-based” exception. This appears to be a revocation by the IRS of its guidance in its above-referred 1999 and 2006 rulings. Consequently, the mere presence of such typical contingency language would taint the payment of a bonus even where the performance goals were in fact met.

The IRS’ position in Private Letter Ruling 200804004 now brings into question a public company’s current entitlement to deduct (or to have deducted in the past) payments of what at the time was believed to be “performance-based compensation.” Public companies need to review their existing and contemplated performance plans to see how this new position may affect them. Are disclosures required? Should amended tax returns be filed? Should plans be

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modified? How should new plans be treated? What alternatives are available?

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