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IRS CHANGES POSITION ON KEY SECTION 162(m) ISSUE

The IRS made public on January 25, 2008, a private letter ruling (PLR 200804004) that signals a major change in its rulings policy on a key Internal Revenue Code Section 162(m) issue. In the ruling, the IRS held that an incentive pay award would not qualify as performance-based compensation exempt from the Section 162(m) $1 million cap where the executive is entitled to payment at target in the event of an involuntary termination or termination for good reason. According to the IRS, the mere possibility of payment in these circumstances taints the compensation and makes it impossible to qualify as performance-based under Section 162(m).

In two previous private letter rulings, one released as recently as 2006 and another issued in 1999, the IRS had reached the opposite conclusion. In both of the previous rulings, the Section 162(m) issue was the central holding.

Section 162(m) applies to public companies. It disallows U.S. federal income tax deductions for compensation paid to certain executive officers in excess of $1 million per executive per year, unless an exception applies. The most important exception is for performance-based compensation. One requirement for performance-based compensation is that the compensation must be payable solely on account of the attainment of the performance goals. Elaborating on this requirement, the Section 162(m) regulations specifically provide that compensation will not fail to satisfy this requirement merely because the arrangement allows the compensation to be payable upon death, disability, or change in control.

The IRS—explicitly in the 1999 ruling and implicitly in the 2006 ruling—reasoned that involuntary terminations and terminations for good reason were similar to terminations as a result of death, disability, or change in control, and proceeded to rule favorably. In contrast, in the recent ruling, the IRS reasoned that the provision allowing for payment in the event of involuntary termination or termination for good reason did not meet the exception for termination in

the event of death, disability, or for a change in control, and ruled adversely.

As a reminder, IRS private letter rulings apply only to the taxpayers who request them. They may indicate, however, how the IRS views an issue more generally, including on audit. If this were to occur in this case, we would not be surprised if the dispute resulted in litigation.

We believe that the new IRS position is misguided. As the IRS initially ruled, payments in the event of involuntary termination or termination for good reason are sufficiently similar to payments in the event of death, disability, or change in control to justify the same favorable treatment under Section 162(m). Moreover, the new IRS position produces anomalous results. Section 162(m) will rarely apply to a bonus payment that is guaranteed on a termination of employment because employment termination normally shuts off Section 162(m). Meanwhile, the mere possibility of such a payment may now have the illogical effect of causing Section 162(m) to apply to a bonus payment that is completely performance-based. This makes little sense. At the very least, if the IRS were to maintain its new position, we would urge that they do so only prospectively.

This issue is of critical importance to many public companies. The amount of deductions at stake is substantial in some cases. Moreover, in the case of all public companies, the SEC requires a statement in the proxy of the company's policy with respect to Section 162(m). While specific items do not need to be addressed, the availability of the performance-based exception should be a factor that a company considers in forming and articulating its policy.

In light of this ruling, each public company should consider the following. First, it should identify any of its bonus or incentive pay plans or programs that are intended to qualify as Section 162(m) performance-based compensation and determine if they may be potentially affected. Completion of this step will require a review of the particular plans or programs, as well as any related employment or severance agreements that may guarantee a level of incentive pay in the event of involuntary termination or termination for good reason. Second, it should consider any potential effect to its statements made or to be made in its proxy. Finally, it should be aware of potential alternatives. For example, for prospective awards, it could provide in the case of an involuntary termination or termination for good reason that the executive would be entitled to a payout (full or pro-rata) based on the corporation's actual performance for the entire period. Since no amount would be guaranteed, such an award still should qualify as performance-based (assuming satisfaction of the other Section 162(m) requirements such as shareholder approval and a properly constituted compensation committee).

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