Deduction At Risk: IRS Changes Position on Performance-Based Compensation Exception Under Section 162(m)

The Internal Revenue Service recently issued Private Letter Ruling 200804004 ("PLR") which appears to significantly limit the ability of publicly held corporations to use the performance-based compensation exception under Section 162(m) of the Internal Revenue Code. The PLR provides that compensation will not be considered "performance-based compensation" if it may be paid on account of an employee's termination without cause or for good reason without regard to whether the relevant performance goals have been attained. The PLR represents a substantial change in the position of the IRS with respect to this issue.

Section 162(m) generally prohibits a publicly held corporation from deducting compensation paid to "covered employees" in excess of $1 million in any year. A corporation's covered employees are its principal executive officer and three other highest paid officers (not including the principal financial officer).

Payments that qualify as performance-based compensation do not count towards the $1 million limit under Section 162(m). Generally, in order to qualify as performance-based compensation, the compensation must be payable solely on account of the attainment of one or more pre-established performance goals. The regulations under Section 162(m) provide that payments do not fail to be performance-based compensation because an arrangement allows the compensation to be payable upon death, disability or a change in control, although compensation actually paid on account of those events would count towards the $1 million limit. In two previous private letter rulings, the IRS extended this rule to compensation paid on account of a termination without cause or for good reason.

In a change of position by the IRS, the PLR provides that compensation paid to a covered employee will not be treated as performance-based compensation for purposes of Section 162(m) if, without regard to whether the relevant performance goals are met, the compensation could be paid on account of the employee's termination without cause or for good reason. Accordingly, compensation payable to a covered employee under these circumstances counts towards the $1 million limit under Section 162(m) and could result in a loss of deduction for the corporation if the employee's total compensation exceeds $1 million in the applicable year.

(continued)

Recommended Actions

A private letter ruling only applies to the taxpayer to whom it is addressed. However, private letter rulings generally are viewed as an indication of the IRS's position with respect to the issue addressed. Therefore, we recommend that publicly held corporations consider taking the following actions:

- Identify and Review Plans. Identify all arrangements under which covered employees may receive compensation, including cash incentive plans, equity-based compensation plans, employment agreements and severance arrangements, and determine whether such arrangements provide for incentive compensation on account of a termination without cause or for good reason.

- Tax Treatment of Compensation. Consult with their tax accountants and auditors to discuss the impact of the PLR on previous deductions taken for compensation paid to covered employees in excess of the $1 million limit.

- Consider Plan Design Changes. Consider whether current arrangements should be revised to reflect the IRS's position in the PLR. Also consider whether the affected employee's consent will be needed to amend the arrangement and the impact of the deferred compensation rules under Section 409A of the Internal Revenue Code on any amendment.

- Securities Law Considerations. Consider the impact of the PLR on proxy statements, other public disclosures and prospectuses that address the deductibility of compensation paid to covered employees.

This Client Alert is for general information purposes and should not be regarded as legal advice. If you have any questions, please contact Anthony C. Ciriaco (614.464.6429), Wendy M. Swary (614.464.6495), Alan D. Duffy (614.464.5425), Amy M. Stuckey Swank (614.464.6461), or your Vorys relationship attorney.

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