

Contributing Authors

Linda A. Wilkins
214.740.8538
lwilkins@lockelord.com

Laurence A. Hansen
312.443.0456
lhansen@lockelord.com

www.lockelord.com

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IRS Ruling Puts Deductibility Of Performance-Based Compensation In Question

On January 25, the IRS issued a private letter ruling denying an employer a deduction for incentive bonuses under Section 162(m) of the Internal Revenue Code (the “Code”) which generally limits deductibility to \$1 million, ruling that the bonuses did not qualify as “performance-based compensation.” This ruling directly contradicts earlier private letter rulings favorable to public companies seeking to qualify performance-vesting awards for deduction under Section 162(m) of the Code.

Section 162(m) applies only to public companies. It denies a deduction for compensation paid in excess of \$1 million in one year to a company’s top five employees (those listed in the annual proxy summary compensation table). One common way to avoid the limit is to structure compensation awards (such as bonuses, restricted stock and restricted stock units) as “qualified performance-based compensation.” If the compensation committee of the board of directors establishes performance goals approved by the stockholders, and assures that the goals are met prior to payment or vesting, then the award is deductible regardless of the amount. (Stock options can satisfy another rule and the compensation generated upon exercise is generally deductible under Section 162(m). Stock options are not affected by this ruling.)

To qualify for the performance-based compensation exception under Section 162(m), an award must be payable only upon attainment of pre-specified performance goals. The IRS regulations under Section 162(m) provide that compensation will not lose its status as performance-based compensation if it is payable prior to the attainment of the performance goals upon one of three events – death, disability, or change in control. (Of course, if an award is paid upon one of those events prior to the achievement of the goals, the payment would not be performance-based and therefore would not be deductible if

the executive is required to be listed in the proxy for the year, and his or her compensation exceeds \$1 million for the year.) In 1999 and 2006, the IRS issued favorable private letter rulings that recognized two other events that would allow payment prior to the achievement of the performance goals – an executive's involuntary termination without “cause” or the executive's resignation for “good reason.” The 1999 ruling reasoned that terminations without cause and resignations for good reason were involuntary terminations similar to terminations as a result of death, disability or change in control and therefore would not adversely affect the potential for performance-based compensation.

The recent IRS ruling, Private Letter Ruling 200804004, holds that an employment contract providing for accelerated payment of an award upon termination for “cause” or resignation for “good reason” causes the award NOT to be performance-based in its entirety because it could be paid in circumstances other than achievement of the performance goal (or death, disability or change in control). This means that *even if the executive achieves the goals and is paid for that reason, nevertheless THE AWARD FAILS Section 162(m) requirements and is not considered a “performance-based” award.*

Although this ruling is not “binding” on other taxpayers because it is only a private letter ruling, it may represent a change in the IRS position on this issue. In particular, it may reflect a change to a strict reading of the regulations – one that supports only exceptions for death, disability and change in control, but not terminations without cause or resignations for good reason. As a result, we recommend that you review all of your company’s performance-based awards in conjunction with its severance, change of control and employment agreements. If you find there are payment triggers based on termination “without cause,” or resignation for “good reason” (regardless of achievement of performance goals), then

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these payment triggers must be eliminated, or the company's deduction for these awards in the ordinary course would likely be challenged by the IRS.

You should also keep in mind that there are potential adverse tax consequences to using these accelerated payment triggers for "performance bonuses" under Section 409A. Typically, Section 409A permits an executive to make an election to defer a "performance bonus" as late as six months prior to the end of the performance period. However, if the executive is entitled to receive the bonus regardless of performance if his employment is involuntarily terminated (or he quits for good reason) during the performance period, then the normal deferral election rules apply. These rules require that the election be made in the calendar year prior to the beginning of the performance period. These election rules apply to both public and private company employers.

ABOUT THE AUTHORS

Linda A. Wilkins and Laurence A. Hansen are partners in the firm's employee benefits and executive compensation section. They advise companies, compensation committees and executives regarding the design and taxation of compensation programs and benefit plans designed to recruit and retain key personnel.