



eBenefits Alert: New IRS Ruling Affecting 162(m) Performance-Based Compensation

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The IRS just recently issued a revenue ruling (Rev Rul 2008-13) that may affect how some bonus arrangements and employment contracts are structured for "covered employees" of public companies. As of 2007, the IRS is interpreting the term "covered employee" to mean the CEO and the other three most highly compensated officers other than the CFO.

Section 162(m) of the Internal Revenue Code places a \$1 million cap on compensation paid to a covered employee of a public company that can be deducted in a taxable year. There is a very important exception in 162(m) for "performance-based compensation" that most employers take advantage of in one form or another. If compensation is "performance-based" it is not subject to the \$1 million cap. Generally, performance-based compensation is compensation that is contingent upon meeting pre-specified performance goals. (The 162(m) regulations set out the requirements to be performance-based compensation in some detail.) The 162(m) regulations specify that if a bonus plan or other agreement provides that the covered employee is entitled to receive the compensation if he/she doesn't satisfy the performance goals, then the exception doesn't apply. This is the case even if the employee does, in fact, satisfy the performance goals. The regulations carve out an exception for certain events. These are death, disability and a change in control. Under this exception a bonus plan (or other agreement) could provide that an employee can receive a payment before the goals are satisfied in the event of the employee's death, disability or a change in control. If a plan (or other agreement) contains this type of provision, any payments that are actually paid out due to satisfaction of the goals will qualify for the performance-based exception. Put another way, the existence of an exception allowing for a payment that's not contingent on satisfying the goals won't taint any payments that do satisfy the goals, as long as the exception is limited to the employee's death or disability or a change in control of the employer.

Over the years, taxpayers have requested that the IRS extend the exceptions to include other events, e.g., involuntary termination without "cause," voluntary termination for "good reason" and voluntary termination for retirement. In a couple of private letter rulings the IRS did, in fact, allow these additional exceptions. In Rev Rul 2008-13, however, the IRS reversed its position, holding that for purposes of the 162(m) performance-based exception, involuntary termination without "cause," voluntary termination for "good



reason" and voluntary termination for retirement will not be treated like death, disability and a change in control. Thus, if a bonus plan (or other agreement) allows a covered employee to receive a payment in lieu of the bonus payment the employee would have received had he/she worked for the entire performance cycle and satisfied the performance goals, that provision will cause any payment made under the bonus plan to lose the benefit of the performance-based exception, whether or not the payment would actually have qualified for the exception.

A typical situation you might see is one in which a bonus plan provides that covered employees must satisfy pre-specified performance goals to receive stock grants or cash payments consistent with the 162(m) performance-based exception requirements, but a separate employment agreement for the CEO says that if the CEO is terminated without cause or the CEO terminates for good reason before he/she becomes entitled to the bonus payment, the employer will pay the CEO 100% of the bonus payment (assuming all goals were met at target) in an immediate lump sum upon the termination. Under Rev Rul 2008-13, this type of provision will cause the bonus payment to lose the benefit of the 162(m) performance-based exception for the CEO, even if he/she actually remains employed and satisfies the goals under the terms of the plan.

In response to a lot of negative feedback, the IRS included a grandfather provision in Rev Rul 2008-13. Under it, the above-described restrictions don't apply to payments under plans with performance periods that begin on or before January 1, 2009, or under the terms of an employment contract in effect on February 21, 2008.

Again, the ruling applies only to "covered employees" of public companies. It limits the ability to deduct certain bonus compensation paid to these employees. The limit applies only if the bonus plan or employment agreement provides for a payment instead of the bonus payment the employee would have received had he/she satisfied the performance goals. The ruling generally should have no effect on other types of 162(m) performance-based compensation that automatically satisfies the 162(m) performance-based exception, such as stock options and stock appreciation rights.

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