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Client Alert: IRS Reverses Position under Section 162(m) Regarding "Good Leaver" Impact on Performance-Based Compensation Provisions

February 15, 2008

This memorandum was not intended or written to be used, and cannot be used, for the purpose of avoiding tax-related penalties under federal, state, or local tax law.

In a private letter ruling ("PLR") released on January 25, 2008,[1] the Internal Revenue Service ("IRS") has modified a long-standing position regarding Section 162(m) of the Internal Revenue Code ("Section 162(m)"). The PLR concluded that an otherwise allowable deduction for performance-based compensation under Section 162(m) will be disallowed if that compensation is eligible to be paid upon an executive's termination without "cause" or resignation for "good reason" – even if the executive's employment is not in fact terminated and the executive earns the compensation based on actual performance. The PLR decided that the mere *possibility* of receiving payment upon or following an executive's involuntary or constructive termination, without regard to actual performance achievement, would taint an entire arrangement from a Section 162(m) standpoint.[2] This recent PLR contradicts two earlier PLRs that the IRS released in 1999 and 2006 addressing the same issue.

Although PLRs do not constitute binding authority for taxpayers other than the one receiving the PLR, we understand that this recent PLR represented a deliberate change in policy by the IRS. Many legal practitioners and accounting firms immediately voiced concerns to the IRS regarding the potential scope and ramifications of this recent PLR, noting the uncertainty it has raised with respect to companies' tax returns, financial statements and proxy statements. In a February 14, 2008 webcast teleconference, Kenneth Griffin, who authored the recent PLR, noted that the IRS has heard the concerns that have been raised "loud and clear" and that the IRS is currently working on issuing further public guidance to alleviate some of the concerns that have been raised by the PLR. While Mr. Griffin did not offer any specific details, he said the IRS hopes to have the new guidance issued by the end of February, and he recommended that companies not make any drastic changes to their existing compensation arrangements in response to the PLR before the guidance is released. ***In light***

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1 PLR 200804004.

2 Note that stock option grants with an exercise price that is no less than the grant date fair market value of the underlying stock and other incentive compensation arrangements which remain subject to performance achievement following an executive's involuntary or constructive termination should not be affected by the recent PLR.

of the IRS' informal indication that further guidance is forthcoming, companies may wish to wait for that guidance before implementing any changes to existing incentive arrangements in order to avoid making changes that could ultimately prove to be unnecessary or potentially inadequate.

By way of general background, Section 162(m) generally disallows a publicly held corporation from claiming deductions for compensation paid to a "covered employee" in excess of $1,000,000 per taxable year, unless the compensation meets certain requirements detailed under Section 162(m) and the regulations promulgated thereunder to qualify as performance-based compensation. The term "covered employee" generally includes a company's chief executive officer and its next three most highly compensated executive officers (other than the company's chief financial officer) who are serving in such capacities at the end of the company's taxable year.[3] Under Section 162(m), an amount will not qualify as performance-based compensation "if the payment of compensation under a grant or award is only nominally or partially contingent on attaining a performance goal." However, the regulations also state that a plan provision providing for the *possibility* of payment due to death, disability, or change of ownership or control will not taint an otherwise compliant performance-based compensation arrangement from a Section 162(m) standpoint with respect to executives who in fact receive their payments based on actual performance achievement. The earlier PLRs extended this principle from death, disability and changes of control to involuntary and constructive termination events.

The fact that the IRS has informally changed its policy from a private letter ruling standpoint does not necessarily mean that the IRS' new position is correct as a matter of law. However, in light of the uncertainty raised by the recent PLR, we understand that some of the major accounting firms have at least preliminarily concluded that they may not be able to get to a "more likely than not" comfort level for tax reporting for companies that claim deductions under the circumstances described in the recent PLR, in which case the accountants may require companies claiming such deductions to make specific disclosure in their tax returns and take a corresponding tax reserve on their financial statements.

From a practical standpoint, while clients may wish to wait for the anticipated further guidance from the IRS before taking any actions in response to the recent PLR, some or all of the following interim steps could be considered:

- ***Analyze Existing Incentive Arrangements and Corresponding Executive Employment Agreement Provisions***. As a preliminary matter, companies may wish to review whether any of their compensatory arrangements that are intended to qualify as Section 162(m)

[3] Following the SEC's rule changes in 2006 regarding which executives must be included as "named executive officers" for compensation disclosure purposes, the IRS provided that it will interpret the term "covered employee" for purposes of Section 162(m) as not including a company's principal financial officer (regardless of his or her compensation level) and only including three executive officers other than the company's principal executive officer.

performance-based compensation arrangements (e.g., annual or long-term bonus arrangements or "performance share" or "performance unit" awards) provide for payments to be made in connection with an involuntary or constructive termination of an executive's employment, *without regard to actual performance achievement*.

- ***Discuss the Potential Impact of the PLR with the Company's Accountants***. To the extent that a company identifies incentive compensation arrangements that may be affected by the recent PLR, the company's outside auditors could assess the potential impact on current and past years' tax returns and financial statements.

- ***Review the Company's Section 162(m) Proxy Statement Disclosure***. Proxy statement disclosure typically includes a statement regarding the company's general "philosophy" regarding incentive compensation and Section 162(m), so a company may want to revisit its disclosure in light of the recent PLR.

If you have any questions regarding these important developments, please do not hesitate to contact any of the following or your Simpson Thacher relationship partner:

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