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Update: IRS Issues Transition Relief, but Affirms Its New Position under Section 162(m) Regarding "Good Leaver" Provisions

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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.

On February 21, 2008, the Internal Revenue Service ("IRS") issued a revenue ruling (the "Revenue Ruling")[1] generally affirming and formalizing its new stance regarding the potential adverse impact of certain "good leaver" provisions on compensatory arrangements that are intended to qualify as "performance-based" under Section 162(m) of the Internal Revenue Code ("Section 162(m)"). However, the Revenue Ruling also provides some transition relief for certain existing arrangements, which should partially alleviate some of the concerns that were raised when the IRS' new position was first made public with the January 25, 2008 release of its private letter ruling ("PLR") addressing the same issue.[2]

Consistent with the recent PLR, the Revenue Ruling provides that a deduction for compensation otherwise qualifying as performance-based compensation under Section 162(m) will be disallowed if the arrangement provides for the *possibility* of payment, irrespective of actual performance, upon an executive's termination of employment without "cause", resignation for "good reason" or voluntary retirement (even if the executive actually remains employed and ultimately earns the compensation based on actual performance). However, as transition relief, the Revenue Ruling also provides that the aforementioned "good leaver" payment opportunities will not disqualify an otherwise compliant performance-based compensation arrangement if the performance award relates to a performance period commencing on or before January 1, 2009, or if the payment is made pursuant to an existing employment agreement as in effect on February 21, 2008.

BACKGROUND

Section 162(m) generally disallows deductions by a publicly held corporation for compensation paid to its chief executive officer and the three most highly compensated executives, other than the chief financial officer, in excess of $1,000,000 per taxable year, unless the compensation qualifies as performance-based compensation. Compensation will qualify as performance-based compensation

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1 Rev. Rul. 2008-13.

2 Our February 15, 2008 client alert addressing PLR 200804004 can be found on our website at http://www.simpsonthacher.com. As noted in that client alert, PLR 200804004 represented a reversal of position for the IRS as compared to prior PLRs which had addressed the same issue.

under Section 162(m) if (in addition to meeting certain other requirements) it is "payable solely on account of the attainment of one or more performance goals," but 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." The Section 162(m) regulations state that a plan provision providing for the *possibility* of payment due to death, disability, or change of ownership or control will not disqualify an otherwise compliant performance-based compensation arrangement where the executives in fact receive their payments based on actual performance achievement. Although the IRS had previously extended this principle (pursuant to PLRs released in 1999 and 2006) from death, disability and changes of ownership or control to involuntary and constructive termination events and voluntary retirement, the IRS' more recent PLR, and now the Revenue Ruling, take the narrower view that the possibility of receiving payment due to involuntary or constructive termination of employment or a voluntary retirement will generally taint an otherwise compliant performance-based arrangement, subject to the limited transition relief issued under the Revenue Ruling.

TRANSITION RELIEF

The Revenue Ruling generally allows any performance-based compensation arrangement with the potentially problematic "good leaver" provisions to qualify as "performance-based" compensation for purposes of Section 162(m) where either (i) the performance period related to the compensation begins on or before January 1, 2009 or (ii) the compensation is paid pursuant to the terms of an employment agreement as in effect on February 21, 2008 (without giving effect to future mutually agreed to or automatic renewals or extensions). Therefore, for example, a company with a calendar year fiscal year should generally be "grandfathered" under the Revenue Ruling with respect to annual and long-term incentive compensation programs based on 2008 and 2009 full calendar year performance, assuming that the arrangements in question meet the general requirements under Section 162(m) to qualify as performance-based compensation (other than with respect to the potentially problematic "good leaver" payment provisions described in the Revenue Ruling). Unlike PLRs, which cannot be relied upon by taxpayers other than the taxpayer to whom the PLR is addressed, revenue rulings may be relied upon by taxpayers generally. Thus the transition relief provided under the Revenue Ruling should give public companies in general some breathing room to assess the extent to which future years' incentive arrangements may be affected by the Revenue Ruling.

PROSPECTIVE ACTION

In light of the Revenue Ruling, clients may wish to review existing (or new or amended) compensatory arrangements that are intended to qualify as Section 162(m) performance-based compensation arrangements (e.g., annual or long-term bonus arrangements or "performance share" or "performance unit" awards) to determine whether the operative plan documents or any executive employment agreements provide for payments to be made in connection with an involuntary or constructive termination of an executive's employment or upon voluntary retirement, *without regard to actual performance achievement*. To the extent that existing, new or amended arrangements would

not meet the requirements set forth under the Revenue Ruling, clients may wish to consider whether to revise such arrangements before the end of the applicable transition relief period under the Revenue Ruling.

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