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IRS Reverses 162(m) Position, Jeopardizing Deductions for Some Public Company Performance Pay Plans. . . Financial Statement Impact Ahead?

A recent Internal Revenue Service Private Letter Ruling held that a public company would not be permitted to take a tax deduction for executive performance compensation paid under a plan that was specifically designed to be exempt from the $1 million deduction limitation of Internal Revenue Code Section 162(m). In this case, the IRS concluded that the Section 162(m) exemption for performance-based compensation will never be available because the incentive could be paid out, without regard to performance results, if the executive were to be fired without cause or to quit for good reason before the end of the performance period. That is -- there will be no escape from the Section 162(m) limitations, even if the executive in fact stays on the job and delivers the performance results!

The January 25 Private Letter Ruling is sure to cause widespread confusion because it squarely contradicts -- but does not mention -- two earlier IRS PLRs which bless arrangements of this type. Many companies would be affected by this new IRS position because executive employment contracts and performance pay plans commonly waive performance vesting conditions upon discharge without cause or quit for good reason. Affected arrangements include annual and multi-year performance bonus plans, performance-vesting restricted stock and a wide variety of other performance-vesting arrangements.

We hope that the Service acts quickly to rescind this new Private Letter Ruling. We think that this latest PLR did not adequately analyze the key Treasury Regulation, which can be read to support both the earlier IRS PLRs and the widespread corporate practice. Of course, Private Letter Rulings do not have the force of a Treasury Regulation or an official published IRS Revenue Ruling. However, PLRs are studied carefully as an indicator of the Service's current thinking on different tax issues.

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Background

Section 162(m) of the Internal Revenue Code limits to $1 million per person the amount of compensation deduction a public corporation can take in any one year for compensation paid to the corporation's top officers. Under a special exemption, compensation over $1 million is deductible in cases where the excess represents performance-based compensation under a shareholder-approved plan, and the compensation goals and targets have been set in advance by a committee of outside directors, which must also certify that the performance goals have been met before any payments are made.

The key Treasury Regulation clearly provides that performance pay arrangements will not automatically be disqualified from using the Section 162(m) exemption just because the performance pay promise is coupled with an alternative commitment under which the executive might be paid the compensation without regard to the otherwise-applicable performance goals. Under the Regulation, the mere existence of an alternative non-performance commitment will indeed sometimes disqualify a deduction for the performance pay, where, for example, the substance of the alternative arrangements renders the performance conditions illusory.

On the other hand, the Regulation also describes alternative arrangements under which non-performance payouts can be coupled with performance pay commitments without killing the availability of the Section 162(m) exemption for the performance payout (if it is ultimately earned): these are cases where the performance conditions will be waived and the payment will vest if the executive dies or becomes disabled or a change of control occurs. Stated differently, under the existing Treasury Regulations, if the executive in fact delivers the performance results and accordingly earns the performance bonus, the employer will be permitted to use the Section 162(m) exemption in order to fully deduct the performance bonus, even though the same bonus would have been paid, without regard to performance results, if, before the end of the performance period, the executive had died or become disabled or a change-of-control had occurred. IRS Private Letter Rulings in 1999 and 2006 held that permitted alternative commitments would include not only death, disability etc., but also discharge without cause or quit for good reason. The January 25 PLR seems to interpret the Regulation as setting out an exclusive list -- rather than an illustrative list -- of permitted tandem arrangements.

The $1 million deduction limit of Section 162(m) generally does not bar tax deductions for compensation paid after a top executive leaves employment. So, the compensation considered in the new PLR might be fully deductible by the employer if the executive was paid without regard to performance after being fired without cause; however, it would not be deductible, according to this PLR, if the executive stayed and earned the bonus on account of successful performance!

Financial Statement Implications

If the Service's rule were applied retroactively, the amount of "improperly" taken corporate tax deductions might run into the billions. If it were applied on a prospective basis, financial statements would have to anticipate non-deductibility as to performance bonus amounts currently reserved or being expensed. With 10-K completion and proxy season shortly ahead, the

unexplained Service rejection of its earlier position and widespread practice is disturbing indeed. Again, we hope the Service acts quickly to resolve the uncertainties created by this new PLR.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. For more information on the foregoing, please call Rob Fleder (212-373-3107) or
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