AKIN GUMP
STRAUSS HAUER & FELD LLP
Attorneys at Law

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EMPLOYEE BENEFITS ALERT

IRS REVERSES ITS POSITION RELATING TO DEDUCTIONS FOR COMPENSATION IN EXCESS OF $1 MILLION UNDER RECENT PRIVATE LETTER RULING

In a recently issued private letter ruling, the Internal Revenue Service (IRS) reversed the position it had taken in two prior private letter rulings by concluding that an incentive award designed to qualify as performance-based compensation under Section 162(m) of the Internal Revenue Code (Code) failed to so qualify because the executive officer was entitled to receive a pro rata portion of the incentive award upon a termination of his employment by the employer without cause or by a resignation for good reason (under which circumstances the award would be calculated as if the performance goals had been achieved). The IRS reached this conclusion even though the executive's right to payment of the pro rata incentive award upon termination was in his employment agreement and not in the plan governing the incentive award.

Section 162(m) of the Code generally prohibits a public corporation from deducting more than $1 million of compensation (per person) paid to its chief executive officer (CEO) and the three highest-paid officers (other than the CEO and chief financial officer) in any one year. However, compensation in excess of $1 million is deductible if it qualifies as performance-based compensation under Code Section 162(m)(4)(C) and the regulations thereunder. One of the requirements of the performance-based compensation exception is that compensation be payable only if previously established performance goals are achieved. However, Treasury Regulation Section 1.162-27(e)(2)(v) specifically provides that this requirement will not be violated if a plan permits the performance-based compensation to be paid upon death, disability or change of ownership or control without regard to the attainment of performance goals (although compensation actually paid on account of such events prior to the attainment of the performance goal would no longer qualify as performance-based compensation).

In private letter rulings issued in 1999 (PLR 199949014) and 2006 (PLR 200613012), the IRS extended this favorable treatment to performance-based compensation that is payable upon a termination of employment by the employer without cause or by an executive for good reason without regard to the attainment of performance goals. In the 1999 ruling, the IRS specifically ruled that these termination events were "involuntary terminations similar to terminations as a result of death, disability or change in control."

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On January 25, 2008, the IRS reversed this long-held position in PLR 200804004, ruling that an incentive award failed to qualify as performance-based compensation because the award was payable upon a termination without cause or for good reason without regard to whether performance goals were achieved. In the ruling, a corporation had adopted a plan that provided for various incentive awards intended to qualify under the performance-based compensation exception to Code Section 162(m). The corporation and one of its named executive officers had entered into an employment agreement that provided that if the executive was terminated by the corporation without cause or resigned for good reason, the previously established performance goals would be deemed to be achieved and the executive would receive a pro rata share of his target incentive award under the plan for the year in which his employment ended. Because the employment agreement created the possibility that the executive could receive a portion of his incentive award without actual achievement of the performance goals (i.e., if the executive was terminated by the corporation without cause or he resigned for good reason), the IRS ruled that the incentive award did not qualify as performance-based compensation. Accordingly, the incentive award would not be deductible by the corporation to the extent it exceeded the $1 million limitation imposed by Code Section 162(m), even if the applicable performance goals were achieved.

Although the new ruling contradicts its 1999 and 2006 rulings, the IRS did not explain why it changed its position on this issue and did not provide companies with any guidance for dealing with the new ruling (or any indication as to whether it will provide relief for arrangements that were entered into in reliance on its 1999 and 2006 rulings).

Although PLRs generally do not have precedential value, they are an indication of the IRS' current view on a particular issue and how the IRS may rule in similar cases. Thus, the significance of PLR 200804004 cannot be overstated. Public companies should review all plans and arrangements that are intended to qualify for the performance-based compensation exception to Code Section 162(m), including all annual and long-term performance-based plans, performance-based restricted stock (or stock unit) plans and agreements, and individual employment agreements with executives who are subject to, or could become subject to, the Code Section 162(m) limitation, and should discuss the implications of the new ruling with their lawyers and accountants.

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CONTACT INFORMATION

If you have questions regarding this alert or the implications of PLR 200804004, please contact:

Bruce Simonetti .... 212.872.8023 .... bsimonetti@akingump.com .... New York
Tristan Brown .... 212.872.1083 .... tbrown@akingump.com .... New York
Robin Schachter .... 310.728.3363 .... rschachter@akingump.com .... Los Angeles

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