STROOCK

SPECIAL BULLETIN

Section 162(m) Alert: Got Performance?

Transition Relief Expires on December 31, 2009 for Performance-Based Compensation Arrangements with Certain Termination Triggers

November 23, 2009

Overview and Recent Changes in Internal Revenue Service Position

Section 162(m) of the Internal Revenue Code of 1986, as amended ("Section 162(m)") prohibits most U.S. companies reporting under the Securities Exchange Act of 1934 (*i.e.*, most U.S. public companies) from deducting compensation over $1 Million to their "named executive officers" (generally, a company's CEO and its three most other highly compensated officers) unless such compensation is "performance-based" compensation. The proxy reporting rules under the Securities Exchange Act also require robust disclosure about a company's policy concerning Section 162(m), including the reasons a reporting company chooses to comply (or chooses not to, or fails to, comply).

One of the primary conditions of the performance-based compensation exception is that the performance condition of any grant or award established by an independent compensation committee be met.[1] Examples of performance-based compensation include annual performance bonuses, long-term incentive plans where the performance periods span more than one year, and equity-based awards where the grant or the vesting of the award is contingent upon satisfaction of one or more performance goals.[2]

In 2008, the Internal Revenue Service (the "Service") released Revenue Ruling 2008-13, in which it concluded, contrary to the established practice of many reporting companies, that notwithstanding the establishment of otherwise valid performance goals, compensation will not be deemed to constitute performance-based compensation if the compensation may be paid where the covered employee terminates employment without cause, for good reason, or due to retirement. This is true, concluded the Service, even if the performance goal is ultimately attained and/or the non-performance payment trigger never occurs.

In private letter rulings issued before 2008, the Service had taken the view that payments that would otherwise qualify as performance-based would not fail to qualify, even if the applicable plan permitted payment without regard to attainment of the performance goal in the event of termination without cause, for good reason, or due to retirement. The Service had unexpectedly reversed this position in Private Letter Ruling 200804004, ruling that compensation that would otherwise qualify as performance-based, but which could become payable without regard to performance in the event of termination without cause or for good reason, would not qualify for the performance-based exception. Revenue Ruling 2008-13 confirmed and broadened the new position set forth in Private Letter Ruling 200804004.[3] Because the Service acknowledged that some companies could view these pronouncements as departures from prior practice, it provided transition relief in order to address the concerns of public companies that relied on its prior position.

This limited transition relief provides that, notwithstanding the Revenue Ruling's position, compensation that otherwise meets the requirements for qualified performance-based compensation will not be disqualified from performance-based compensation if either (i) the performance period for 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 regard to future renewals or extensions). For this purpose, the "performance period" for the compensation is the period of service to which the applicable performance goal relates. This means, for example, that if a performance-based bonus arrangement relates to an annual calendar year performance period, then the bonus will no longer qualify as performance-based compensation under Section 162(m) for any year after 2009 if it could potentially be paid without regard to attainment of the performance goal in the event of termination without cause, for good reason, or due to retirement.

Action To Be Taken

Public companies that have not already done so should review bonus and other compensation arrangements that have been structured to qualify as performance-based compensation exempt from the deduction limitation of Section 162(m), and consider whether amendments should be made in order to fully preserve the deduction for performance periods beginning after this year.[4] Review should include not only the particular bonus or other compensation arrangement, but also the terms of a covered employee's employment, severance or other agreement that may provide that payment will be made (or vesting will accelerate), without regard to the applicable performance goal, in the event of termination without cause, for good reason, or due to retirement. Of course, companies should also use this as an opportunity to review and refine their compensation design and practices in light of broader trends.

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1. There are other conditions to the performance-based exception under Section 162(m), including that the independent compensation committee certify that the performance condition has been met in advance of any payment and that certain information concerning the performance goals that may be utilized by the compensation committee be disclosed to, and approved by, shareholders.
2. There is also an exception for non-discounted stock options and stock appreciation rights granted under a plan that (a) is administered by a committee of "outside directors"; (b) is approved by shareholders; and (c) contains an individual limit on grants to covered employees. Such grants are deemed to be performance-based and are not affected by the Service's new position in Revenue Ruling 2008-13.
3. Private Letter Rulings are binding on only those parties who request the ruling. Nevertheless, many practitioners find them useful to convey current thinking of the Service. A Revenue Ruling has broader applicability and is not just limited to the party that requested it. In addition to having application to more parties, the Revenue Ruling also held that the exception would not be available where the compensation would be paid upon retirement without regard to attainment of the performance goal.
4. With respect to employment agreements which are extended or renewed after February 21, 2008 (including under automatic or "evergreen" renewal provisions), companies should similarly consider whether any amendment is needed to continue to rely on the performance-based exception under Section 162(m); however, the date by which such an amendment would be needed depends on the applicable extension or renewal date.

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