

Transition Period Expires for Certain New IRS “Section 162(m)” Rules for Performance-Based Compensation

Section 162(m) of the Internal Revenue Code limits to \$1 million the deduction that a publicly held corporation may claim in any year for compensation to its CEO or any of its three most highly paid named executive officers other than the CEO or the CFO. An important exception makes the deduction limitation inapplicable to qualifying “performance-based” compensation. Complying with the performance-based compensation exception involves ongoing attention to sometimes changing rules, and for some employers may require prompt action in 2010.

In a reversal from the position taken in several earlier private rulings, the IRS issued a 2008 Revenue Ruling to the effect that a qualifying performance-based arrangement could not guaranty a payout (for example, a prorated target bonus) as severance protection under an otherwise qualifying performance-based award. The IRS reasoned that this type of severance protection is incompatible with the requirement that exempt awards pay out *only* if pre-established, objectively determinable performance goals are met. Certain earlier private rulings had interpreted the regulations to permit a qualifying award to pay out without regard to performance on an involuntary separation or a retirement, as well as in other exceptional cases expressly recognized by the regulations (death, disability or a change in control).

In its 2008 Revenue Ruling, the IRS gave taxpayers a transition period in which to adapt their arrangements to the new rules. In general, the IRS’s new position applies to performance periods that begin *after* January 1, 2009. (A separate transition rule may apply to certain employment agreements.) Thus, for example, for a calendar-year corporation with an annual performance-based bonus plan, the new rules would typically apply first to performance-based awards for calendar 2010.

Steps may need to be taken promptly, in advance of new grants of award opportunities, to ensure that awards for 2010 or later performance periods qualify for the performance-based exception. For an arrangement that currently offers severance protection, first steps could be to identify the extent to which the protection being offered may run afoul of the new rule in the 2008 Revenue Ruling and then, to the extent warranted by this initial review, examine possible structuring alternatives to address the issue.

If you would like advice regarding these matters, please feel free to contact your regular Ropes & Gray advisor.