

IRS denies 162(m) performance-based compensation exemption for awards with severance protection

In a dramatic reversal of prior positions, the IRS in newly released Private Letter Ruling (PLR) 200804004 has ruled that a performance award providing for payout at target on a mid-period involuntary termination or “good reason” quit *does not qualify* for the performance-based compensation exemption under Section 162(m) of the Internal Revenue Code. As a result, the IRS ruled, *no* payments under the arrangement will qualify for the exemption, even if paid following attainment of the specified performance goals.

Section 162(m) limits to \$1 million annually the amount that a public company can deduct for compensation to each of the CEO and certain executive officers. However, this limit does not apply to “performance-based compensation.” Qualifying performance-based compensation must be payable only if preestablished, objective performance goals are attained.

Regulations under Section 162(m) contain an explicit death/disability/change in control exception to the “pay-only-upon-performance” rule. The possibility that a payment may be made in those exceptional circumstances without regard to performance does not mean that other, performance-based payments made in the ordinary course cannot qualify for the performance-based compensation exemption.

In earlier private letter rulings, the IRS had extended the rationale of the regulations’ death/disability/change in control exception to severance protection (payouts on an involuntary termination or a “good reason” quit) and to a payment on retirement.

PLRs are not designed to provide generalized guidance. PLRs are issued to individual taxpayers upon request and may not be relied on by other taxpayers. However, PLRs are widely viewed as reflecting the IRS’s position. PLR 200804004 does not offer any hint as to why the IRS has changed its views, or any promise of transition relief.

In many calendar-year companies, the terms of performance awards are under consideration right now (the Section 162(m) deadline for establishing the performance goals in most calendar-year plans is late March). Some companies may want to reconsider severance protection features in their programs, although many of these protections are contained in individual agreements. In any case, public companies that offer severance protection – that is, a promised payout without regard to actual performance – for otherwise performance-based bonuses should review the tax treatment of those programs and consider the effect of the severance protection on the “compensation discussion and analysis” portion of public-company proxy-statement disclosure.

For more information regarding PLR 200804004, please contact a member of the Tax & Benefits Department.

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