Client Alert

February 20, 2008

Deductibility of Accelerated Performance-Based Compensation in Jeopardy

IRS Urges Companies Not to Act Until Further Guidance is Issued

An apparent narrowing of the IRS's interpretation of Section 162(m) could end up forcing companies to choose between preserving the deductibility of performance-based compensation or continuing to allow for accelerated vesting of payouts in some termination scenarios.

Generally, Section 162(m) allows a public company to deduct no more than one million dollars in compensation each for its CEO and next three most highly paid executives, but there is an important exemption from this limit for compensation that qualifies as "performance-based." That exemption is not jeopardized if plans or agreements permit performance-based awards to be paid out upon death, disability or a change of ownership or control, if the accelerating provision is never triggered. In previous private letter rulings (PLRs) issued in 1999 and 2006, the IRS extended this concept to include plans or agreements under which compensation is paid following termination without cause and termination by the executive for good reason, or upon the executive's retirement or reaching a particular age. In one of these private rulings, the IRS specifically noted that termination by the company without cause, or termination by an executive with good reason, were both "*involuntary terminations similar to terminations as a result of death, disability or change-in-control*."

That position has changed. In a private letter ruling released at the end of January, the IRS stated specifically that employment agreements or plans that permit payment of performance unit awards at target upon the executive's termination without cause or by the executive with good reason would not satisfy 162(m)'s performance-based exception – even if the accelerated vesting was never triggered and the executive continues on the job and delivers performance results. The Service attributes its new position to a reconsideration of the relevant issues, including its concern that such a provision permits compensation for poor or non-performance.

PLRs are widely viewed as an indication of the IRS's current thinking, even though the letters cannot be cited or used as precedent by anyone other than the taxpayer involved.

As such, many companies have relied on the interpretations given in the two previous PLRs when adopting plans and agreements that permitted otherwise performance contingent compensation to be payable (either at target or pro-rated based on time elapsed) if the executive was terminated without cause or with good reason.

Consequences of this new position could be significant. When entering a new employment arrangement, companies would be forced to decide whether it is more important to preserve the performance-based deduction, or to offer the executive the benefit of some vesting acceleration upon termination without cause, for good reason or upon retirement. Such provisions have typically been viewed as market practice for executives. Companies also might be put in the position of having to second-guess whether their existing plans or arrangements are deductible, as the IRS will not provide specific relief to companies that relied on earlier PLRs in designing their current plans and/or making payouts.

To complicate matters further, this apparent change of heart by the IRS could have ramifications on corporate financial statements. Under FASB Interpretation No. 48, "Uncertain Tax Positions" (FIN 48), a tax benefit can be recorded for tax deductions only when the company concludes that "more likely than not" its tax position is sustainable. FIN 48 also requires that a company re-evaluate its prior conclusions in response to new information. If the IRS's new stance on deductibility would affect a company's assessment of the sustainability of its previous compensation deductions, it could increase both its tax liabilities and tax expense. Based on this recent ruling, at least one accounting firm is now recommending that companies include a tax reserve in their financial statements if such an acceleration provision is in place.

Questions related to the scope and applicability (retroactive vs. prospective) of this provision, as well as the accounting implications, has caused practitioners great angst in the past month. In recognition of this upheaval, the original author of the PLR has stated that the Service intends to publish further guidance by the end of February to clarify the application of the new position, and urged practitioners to hold off on making any drastic changes to their plans until that time.

> ***PM&P Observation:*** *As the Service will be coming out with further guidance in the next few weeks, we recommend that clients give careful consideration in designing new arrangements to the potential tax and accounting risks of acceleration features, but hold off taking action until more formal guidance is issued. Clients should, however, review their 162(m) proxy disclosure to ensure the discussion accurately reflects the possibility that some awards may not be deductible given the uncertainties described above.*

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