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New Developments Affecting Executive Pay Deductions

The Internal Revenue Service recently issued two rulings relating to the \$1 million deduction limit for executive pay. The first, Private Letter Ruling 200804004, reversed a position stated in previous private letter rulings and concluded that compensation is not performance-based, and thus might not be deductible, if it is payable upon a termination without cause or a resignation with good reason even if stated performance goals are not met. The second, Revenue Ruling 2008-13, confirmed the new position in a formal and binding ruling but also provides that the Service's new position will be applied prospectively.

Background

Section 162(m) of the Internal Revenue Code limits the deduction that a publicly held corporation may claim for compensation paid to its "covered employees" (generally the executive officers whose compensation is reported in the company's proxy statement). Section 162(m) generally provides that the company's compensation deduction for each covered employee cannot exceed \$1 million.

Compensation that qualifies as "performance-based" is not subject to the deduction limitation. For example, if a covered employee receives a salary of \$750,000 and a \$500,000 bonus, the company's deduction for this compensa-

tion is limited to \$1 million unless the bonus qualifies as performance-based. The entire \$1.25 million may be deducted if the bonus satisfies the performance-based compensation requirements.

Compensation is performance-based only if, *inter alia*, it is payable *solely* on account of achieving pre-established performance objectives. This requirement generally means that compensation is not performance-based if it is payable for any reason other than meeting the performance goals. This requirement also prohibits tandem arrangements, *e.g.*, one agreement that calls for payment if the goals are achieved and a separate agreement that calls for payment if the goals are not achieved.

The regulations have an exception to the "solely" requirement. Compensation qualifies as performance-based even though it may become payable upon death, disability or a change in control. The award or agreement can still qualify as performance-based even though it provides for payment in some or all of those events. However, amounts that are paid due to death, disability or a control change will not qualify as performance-based if those payments are made regardless of whether the goals are achieved.

In private letter rulings issued in 1999 and 2006, the Service expanded on the exceptions set forth in the regulations. The earlier rulings concluded that compensation could qualify as performance-based even if it also could become payable on account of a termination without cause or a resignation with good reason. As with the regulatory exceptions, however, amounts paid because of a termination without cause or a quit with good reason would not qualify as performance-based unless the payments were contingent upon meeting the performance objectives.

2008 Private Letter Ruling

The 2008 private letter ruling reversed the position set forth in the 1999 and 2006 rulings. The most recent letter concluded that compensation is not payable “solely” on account of meeting the performance objectives, and therefore is not performance-based, if it could be paid because of a termination without cause or a resignation with good reason. Therefore, none of the compensation payable under an award or agreement qualifies as performance-based if the compensation could be paid because of a termination without cause or a quit with good reason, without regard to whether the performance goals are achieved.

Awards or agreements that provide for payment in the event of a termination without cause or a resignation with good reason, but only *to the extent that the performance objectives are achieved*, are not affected by the 2008 private letter ruling.

Prospective Application

The Service recognized that its new position (a) reflects an about-face

from its earlier (but informal) guidance, (b) was released during the time that many public companies are making awards that are intended to be performance-based and (c) raises financial accounting and deduction issues concerning prior awards and agreements. The Service issued Rev. Rul. 2008-13 to address these concerns, to state its new position in a precedential form and to extend the new position to cover amounts payable on account of retirement.

The Revenue Ruling states that the Service’s new position will be given prospective application only. The prospective application means that certain awards and agreements are “grandfathered” and subject to the interpretations set forth in the 1999 and 2006 letter rulings. Awards and agreements can be “grandfathered” under either of two circumstances:

1. Awards or agreements under which an amount will be payable for a performance period beginning on or before January 1, 2009, are not subject to the new position. The “performance period” means the period of employment that relates to the performance objective. Thus, these awards can be performance-based even though they provide for an automatic payment (without regard to the performance objectives), in the event of a termination without cause, a resignation with good reason or retirement.
2. Compensation payable under the terms of an employment contract in effect on February 21, 2008, is not subject to the new position. Thus, a severance benefit that “vests” the right to receive the compensation upon a termination without cause, a quit with good reason or retirement

can be performance-based even though the payment is made without regard to the performance objectives. Note, however, that this relief is limited to the terms of the contract in effect on February 21, 2008, and ignores any renewal or extension of the contract (including automatic extensions under an “evergreen” provision).

The Bottom Line

Awards and agreements that relate to performance periods beginning on or before January 1, 2009, *are not affected* by the Service’s new position. Thus, the new position will not affect the deductibility of previous awards that otherwise satisfy Section 162(m). The prospective application of the new position also means that companies need not be concerned with the financial accounting issues of applying the Service’s new position to outstanding awards.

Companies can continue to make awards with provisions for automatic payment in the event of a termination without cause, a resignation with good reason or retirement *if* the performance period *begins* on or before January 1, 2009. Of course, compensation that is paid in those events—and without regard to the attainment of the performance objectives—will not qualify as performance-based compensation under Section 162(m). Provisions that allow payment in those events will not affect the right to rely on the performance-based compensation exception if payment is made because the goals are achieved.

Awards that are made for performance periods beginning after January 1, 2009, will be subject to the Service’s new position. If the award provides for pay-

ment, without regard to the performance goals, in the event of a termination without cause, quitting without good reason or retirement, the compensation will not be performance-based (unless it is “grandfathered” under the employment contract exception). Awards using performance periods beginning after January 1, 2009, can qualify as performance-based if any payment due because of a termination without cause, quitting with good reason or retirement, is also contingent on meeting the performance objectives.

Companies should be mindful of the expiration or renewal dates of employment contracts that “vest” an executive’s right to receive compensation that is intended to be performance-based. A company could decide to renew or extend the current contract provisions (recognizing that awards with performance periods beginning after January 1, 2009, will not be performance-based). Alternatively, a company could decide to amend the contract provisions to state that upon a termination without cause, a quit with good reason or retirement,

the executive is entitled to receive this compensation only to the extent that the performance goals are met. Finally, a company could decide to amend the contract provisions so that severance and other termination benefits are not paid with respect to amounts that are intended to be performance-based.

We welcome the opportunity to assist you in your response to the Service’s new position and the transition relief that is available under Rev. Rul. 2008-13.

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