T O O U R F R I E N D S A N D C L I E N T S

M e m o r a n d u m



www.friedfrank.com

February 4, 2008

IRS Reverses Its Position on Effect of Certain Termination of Employment Provisions on Payments Under Performance Based Plans

On January 25th, the IRS released a Private Letter Ruling reversing its previous position on the impact of certain termination of employment provisions on performance based payments intended to be deductible under Section 162(m) of the Internal Revenue Code of 1986, as amended. The ruling involved an executive employment agreement that provided that a performance based award would be accelerated and paid, with target performance levels deemed met, if the executive's employment has been terminated by the company without cause or by the executive for good reason. The ruling held that the award failed to qualify for tax deductibility under Section162(m), even with respect to payments actually made upon the achievement of the award's established performance goals (and not as a result of termination without cause or for good reason). Thus, incentive compensation plans and executive employment or severance agreements that contain provisions accelerating the vesting of performance based awards in the case of termination by the company without cause or by the executive for good reason may be treated as not providing performance based compensation regardless of whether the payments are actually made upon attainment of performance goals. This ruling is creating serious concern in the executive compensation field. Public companies should consider the impact of this new ruling on their executive compensation arrangements and on their public filings in 2008.

Regulatory Background

Section 162(m) and the regulations thereunder provide that tax deductions may not be taken by a company for compensation paid to "covered employees"[1] for amounts in excess of $1 million per covered employee, unless such payments qualify as "performance based" compensation. The regulations state, however, that a plan may permit acceleration of the performance based compensation upon the death or disability of the executive or a change in ownership of the company without jeopardizing the performance based status of the award. However, payments actually made on death or disability of the executive or a

[1] Under IRS regulations and related guidance in 2007, a "Covered Employee" includes, generally, the principal executive officer and those disclosed as the next three highest paid executive officers other than the principal executive officer and principal financial officer in the company's proxy statement.

Copyright © 2008 Fried, Frank, Harris, Shriver & Jacobson LLP
A Delaware Limited Liability Partnership

change in ownership of the company will not be deductible because the performance goals would not have been met.

IRS Rulings

In the recent ruling, without explanation, the IRS reversed its prior determination that extended the regulation permitting plan provisions that accelerate payment upon death, disability or change in ownership to include terminations without cause or for good reason, or for retirement. The rationale for the prior favorable rulings in 1999 and 2006 by the IRS was that since terminations without cause or for good reason are involuntary, they are analogous to terminations as a result of death and disability. (However, one of the prior rulings permitted a provision providing for accelerated vesting on retirement.)

The recent ruling held that payments may not be treated as performance based compensation even though the payments would normally be made upon attainment of performance goals, if the plan or agreement also provides that the payments would be made at target performance levels on account of a termination without cause or for good reason. The IRS based its new position on the fact that the specific acceleration provisions may result in payments being made regardless of whether the performance goal was attained and, therefore the awards were not in compliance with Section 162(m). Further, it specifically rejected its earlier rationale (without mentioning the prior rulings) regarding the extension of the exception for awards payable upon death, disability, or a change of ownership by stating that these exceptions set forth in the regulations do not extend to the executive's termination without cause or for good reason.

What Companies Should Be Doing Now

Although private letter rulings are directed only to the taxpayer requesting the ruling and may not be cited as precedent, they are generally considered evidence of the IRS's interpretation of the tax code. Thus, plans and agreements designed to provide performance based compensation should be drafted accordingly. In addition, employment termination provisions in current incentive compensation plans and employment or severance agreements should be reviewed to determine what the potential impact may be under the recent ruling. We also understand that in light of the recent ruling at least one accounting firm is now suggesting a tax reserve in the company's financial statements. Companies should discuss the recent ruling with counsel in connection with SEC filings and, for purposes of financial accounting, with their auditors.

* * *

If you have any questions about the foregoing, please call your regular Fried Frank contact or any of the attorneys listed below:

Authors and Contributors

New York		New York	
Laraine S. Rothenberg	+1.212.859.8745	Donald P. Carleen	+1.212.859.8202
Amy L. Blackman	+1.212.859.8620	Howard B. Adler	+1.212.859.8175
		Matthew Behrens	+1.212.859.8238