

LEGAL UPDATES

PUBLISHED: FEBRUARY 8, 2008

New IRS Guidance on Section 162(m)

Service

Employee Benefits &
Executive
Compensation

On January 25, the Internal Revenue Service released Private Letter Ruling (PLR) 200804004, which marks a change to what the IRS considers "performance-based compensation" under Internal Revenue Code (IRC) section 162(m). The PLR held that performance-based compensation that normally would be exempt from the \$1,000,000 deduction limit under IRC 162(m) will not satisfy the performance-based exception if an executive is entitled to payment, whether or not the performance goals are achieved, in the event of involuntary termination or resignation for good reason. According to the ruling, the possibility that an executive could be paid the bonus in these circumstances without the performance goals having been met causes the bonus not to be deductible to the company to the extent the executive's compensation for the year exceeds \$1,000,000.

IRC 162(m) limits the deduction with respect to compensation paid by a public company to its top five executive officers. Legislation broadening the application of the provision was introduced last year, along with a proposal to cap the amount of compensation that could be deferred each year.

This holding contradicts the rulings in at least two prior PLRs, including one published in March 2006. Termination vesting provisions, such as the one described in this PLR, are fairly common in annual and long-term bonus plans and in executive employment agreements. This private letter ruling may suggest tightening views on IRC 162(m) at the IRS and may have implications for tax reporting, compensation committees and shareholder proxy disclosures.

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