

One Minute Memo[®]



IRS Grants Retroactive Relief From §162(m) Letter Ruling

Performance Periods Through 2009, Existing Contracts Grandfathered

The IRS has announced that its controversial letter ruling holding that some common bonus arrangements do not qualify for the performance-based compensation exception to the \$1,000,000 annual cap on deductible compensation will be applied prospectively only.

Internal Revenue Code §162(m) provides that a public company can generally not deduct more than \$1,000,000 in annual compensation paid to its CEO and other officers whose compensation must be disclosed in the annual proxy. "Qualified performance-based compensation" is exempt from the \$1,000,000 limit, but in Private Letter Ruling 200804004 the IRS ruled that a bonus could not qualify for the performance-based exemption if an executive who is terminated without cause or resigns for good reason will receive a bonus based on his bonus target, even if in fact the executive is *not* terminated and the performance goals are met. [Click here](#) to see our prior One Minute Memo dated January 31, 2008 for a fuller discussion of PLR 200804004.

Because the conclusion reached by the IRS in PLR 200804004 was contrary to previous letter rulings, the ruling set off an uproar among public companies understandably concerned about the prospect of having bonuses paid in prior years retroactively classified as nondeductible, and possibly having to restate their earnings to reflect the lost tax deductions.

In response, on February 21, the IRS issued Revenue Ruling 2008-13, which formally restated the conclusion of PLR 200804004 in a public ruling applicable to all taxpayers, but also announced that the new position will be applied prospectively only. Specifically, the IRS announced that compensation that otherwise meets the requirements for performance-based compensation will not be nondeductible solely because an executive could receive the bonus upon termination of employment without cause or resignation for good reason, provided that either:

- The performance period for the bonus begins on or before January 1, 2009. This means that both annual bonuses paid for 2009 (or fiscal years beginning in 2008) and LTIPs with a multi-year performance period beginning January 1, 2009 or earlier are grandfathered; or

- The executive's right to the payment on termination is based on an employment contract that was in effect on February 21, 2008. This protection ceases to apply if the contract is renewed or extended (including automatic extensions under an "evergreen" provision). However, contracts with an indefinite term are apparently protected as long as the contract remains in place.

The IRS also ruled that bonuses that may be paid upon an executive's voluntary retirement are disqualified under §162(m), but are covered by the same grandfather provisions that apply to bonuses paid on termination without cause or resignation for good reason. However, the IRS did not provide comprehensive guidance on the application of §162(m) to other types of bonuses that may be paid prior to the end of the performance period.

However, at the very least the IRS has given public companies some much needed breathing space to consider what changes may be required for bonus plans and employment agreements without being threatened by the retroactive denial of deductions taken in good faith.

If you have any questions about the Revenue Ruling and its possible application to your company's bonus plans, please call the Seyfarth Shaw attorney with whom you work, or any Employee Benefits attorney on our website, www.seyfarth.com.

§409A Issue Unresolved

The IRS also did not address parallel issues arising for both public and private companies under the deferred compensation rules of Code §409A. As described in our prior [One Minute Memo](#), §409A allows an employee to elect to defer "performance-based compensation" up until 6 months before the end of the performance period, and the definition of performance-based compensation is parallel to the definition in §162(m).

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