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One Minute Memo®

Compensation Committees Should Reevaluate Bonus Plans as New IRS Deductibility Rules Take Effect

Performance Periods Beginning January 1, 2010 Are No Longer Grandfathered

As compensation committees meet to set performance targets for 2010, they should keep in mind that the new IRS position regarding the deductibility of bonuses that may become payable if an executive is terminated, resigns, or retires during the performance period goes into effect for 2010 annual bonuses, and that multi-year LTIP performance periods begin January 1, 2010.

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. However, in Revenue Ruling 2008-13, the IRS changed its previous position and ruled that a bonus (or bonus plan) could not qualify for the performance-based exemption if an executive who is terminated, resigns or retires can receive a bonus based on his bonus target even if the performance goals are not met. This is true even if the executive is not in fact terminated or the performance goals are actually met.

In response to pushback from the business community and some members of Congress, the IRS had agreed to grandfather bonuses paid for any performance period beginning on or before January 1, 2009. This means that both annual bonuses paid for 2010 (or fiscal years beginning in 2009) and LTIPs with a multi-year performance period beginning January 1, 2010 are no longer grandfathered, and generally must comply with the new rule.

The IRS also grandfathered any right to a severance payment that is based on an employment agreement, rather than the terms of the bonus plan, if the employment agreement was in effect on February 21, 2008, even if the bonus is paid for a performance period beginning after January 1, 2009. However, if the term of the employment agreement is renewed or extended (including automatic extensions under an "evergreen" provision), the grandfather rule will no longer apply.

Compensation committees need to take the new rules into account in setting the terms of new grants. If the treatment of mid-year terminations is hard-wired into the plan and permits payouts without regard to whether the performance goals are met, the company needs to consider amending the plan prior to April 1, 2010. Plans that permit payouts following termination, but only if performance goals are actually met, should not need to be amended. In addition, plans that provide a payout to executives who die or become disabled, and following a change in control, are still permitted.

Many bonus and incentive plans leave it to the compensation committee to determine the extent to which bonuses will become payable in the case of a mid-year termination; this could also be problematic if the committee regularly allows for payouts regardless whether performance goals are met.

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.