NEW IRS REVENUE RULING LIMITS DEDUCTIBILITY OF CERTAIN PERFORMANCE-BASED COMPENSATION

On February 21, 2008, the Internal Revenue Service (the “IRS”) issued Revenue Ruling 2008-13, which clarifies the IRS’s position on the deductibility of amounts paid by a public company pursuant to certain performance-based compensation arrangements under Section 162 of the Internal Revenue Code (“Section 162(m)”). Generally, Section 162(m) limits to one million dollars an employer’s deduction for compensation paid to any “covered employee” in a given year, unless amounts in excess of this limit qualify as “qualified performance-based compensation.” In order to qualify as qualified performance-based compensation, Section 162(m) generally requires that the compensation be payable \textit{solely} on account of the attainment of performance goals.

In Revenue Ruling 2008-13, the IRS stated that amounts will not constitute qualified performance-based compensation if paid pursuant to an incentive-based plan that includes as a permissible payment event a termination of a covered employee’s employment by the employer without cause, by the covered employee for good reason, or upon retirement, whether or not such amounts are actually paid upon the occurrence of such event. Similarly, if an employment (or other) agreement entitles a covered employee to receive a performance bonus upon such an event under an otherwise compliant bonus plan, no payments made to such employee under the plan will be treated as qualified performance-based compensation. Severance payments continue to be deductible so long as payment is contingent upon the achievement of the applicable performance targets, whether made after the termination of employment or on a prorated basis at the time of such termination.

In recognition of the fact that the IRS’s new position represents a change from previous rulings, Revenue Ruling 2008-13 will not prevent an employer from taking a deduction for any compensation that otherwise satisfies the requirements for qualified performance-based compensation if either (i) the performance period for such compensation begins on or before January 1, 2009, or (ii) the compensation is paid pursuant to the current provisions, and during the current term (without regard to any extensions, whether or not automatic), of a contract as in effect on February 21, 2008.

We recommend that employers take advantage of the prospective application of this revenue ruling by evaluating their current plans and agreements to determine if any modifications are necessary to preserve a deduction. Particular attention should be paid to plans that are currently intended to comply with Section 162(m), employment agreements, and other similar compensatory arrangements with covered employees or with those who may become covered employees in the future.
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