



Employee Benefits and Executive Compensation

October 2009

Reminder – Many Companies Need to Amend for 162(m) by Year End

Many companies will need to amend their employment agreements, equity plans and awards, and other incentive plans and agreements by December 31, 2009, to preserve the deductibility of performance-based awards and amounts under Code Section 162(m) [the \$1 million limit on public companies' ability to deduct compensation payments to their named executive officers] in light of *Rev. Rul. 2008-13*.

Background

Rev. Rul. 2008-13 held that if a plan or agreement provides for payment following an executive's termination without cause, for good reason, or due to retirement, the plan or agreement does not pay "remuneration payable solely on account of the attainment of one or more performance goals," as may be required by Code Sec. 162(m) and Treas. Reg. §1.162-27(e)(2)(i). Therefore, agreements providing for the accelerated vesting of performance-based cash or equity awards and a payment regardless of actual performance upon retirement, termination of the executive by the company without cause, or termination by the executive for good reason, *would cause the awards to fail to satisfy 162(m)'s performance-based exception – even if the accelerated vesting and payout is never triggered.* (The IRS first took this position in PLR 200804004.)

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The IRS' rationale for this position was simple: terminations without cause, for good reason, or due to voluntary retirement, are not listed as permissible payment events under the 162(m) regulations. The IRS has also pointed out that, under the sample definitions of "cause" and "good reason" set forth in the ruling, the involuntary termination may arise as a result of the employee's poor performance and failure to meet the performance goal.

The critical section of the ruling reads as follows:

"The provision in the Agreement allowing for payment of performance share or performance unit awards under the Plan upon Executive's termination by Company without cause or by Executive with good reason does not meet the exception in section 1.162-27(e)(2)(v) of the regulations that allows compensation to be payable upon death, disability or change of ownership or control. Thus, compensation paid to Executive with respect to performance share or performance unit awards is not payable solely upon attainment of a performance goal, for purposes of section 162(m)(4)(C) of the Code."

Effective Date Transition Rules

The IRS declared that it would not apply the holdings in the *Rev. Rul.* to disallow a deduction for any compensation that otherwise satisfies the requirements for qualified performance-based compensation under 162(m) and that is paid under a plan or agreement with payment terms similar to those in the ruling 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 terms of an employment contract as in effect (without respect to future renewals or extensions, including renewals or extensions that occur automatically absent further action of one or more of the parties to the contract) on February 21, 2008.

Thus, compensation paid for 2009 performance under most agreements and programs was exempt.

For most companies, the 2009 performance period is ending and, therefore, the delayed effective date under *Rev. Rul. 2008-13* will not be available much longer. Every company should consider whether it needs to revise its performance-based compensation plans and agreements to comply with *Rev. Rul. 2008-13* and, if it must, how to revise the plans and agreements to achieve the original purposes of the acceleration. Remember, *Rev. Rul. 2008-13* would deny deductibility to plans and agreements with the offending language *even if the acceleration event never occurs*.

Plans and Agreements Affected

A company that wishes to preserve the deductibility of the compensation it pays to senior executives should discuss with counsel and consider changes to the following plans and agreements:

- Annual cash incentive plans,
- Long-term cash incentive plans,
- Equity incentive plans,
- Employment agreements,
- Change in control and severance agreements,
- Equity award agreements, particularly those for performance shares, restricted stock with performance vesting criteria and restricted stock units, and
- Other performance awards.

Companies generally do not need to review or revise arrangements with employees who are not subject to Code Sec. 162(m) – and are highly unlikely ever to become subject to Code Sec. 162(m). However, a company should cast its net broadly, because Code Sec. 162(m) applies in the year the award or other compensation becomes taxable – and deductible by the corporation – which may be several years in the future, after certain employees have been promoted.

For more information, contact your Winston & Strawn employee benefits attorney.

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