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Internal Revenue Service Position on Performance-Based Compensation Changes Effective in 2010

Media scrutiny of executive compensation packages in publicly-traded companies is a clear consequence of the current economic crisis. Even before now, however, executive compensation has been on the regulators' agendas. One of the tools the Internal Revenue Service has in its arsenal is Internal Revenue Code Section 162(m). Changes in how the IRS will enforce Section 162(m) go into effect in 2010.

Section 162(m) prevents public companies from deducting compensation over \$1 million paid in a single year to the company's CEO and four other highest paid officers. A key exception to Section 162(m) is that "performance-based compensation" does not count toward the compensation limit. To meet the definition of performance-based compensation, the compensation must be payable on attainment of performance goals that are set by a compensation committee of outside directors, and the material terms must be disclosed to and approved by the shareholders.

Some employers set up performance-based compensation programs that pay benefits not only on achievement of the goals, but also in the event that the executive retired, was involuntarily terminated without cause, or terminated employment for good reason. In several non-binding private letter rulings, the IRS previously indicated these additional payment triggers were acceptable. But in a 2008 Revenue Ruling, the IRS changed course and determined that the additional payment triggers are not permissible. Specifically, the IRS clarified that compensation will be exempt from Section 162(m) as performance-based compensation *only* if it is payable on achievement of the performance goals, or in the event of death, disability, or change of ownership or control.

Because this ruling represented a dramatic change in position for the IRS, the IRS provided employers with a grace period for compliance. The IRS said that the additional payment events are acceptable in plans where the performance period begins on or before January 1, 2009, and for employment contracts in effect on February 21, 2008. This means that performance based programs in operation for calendar year 2010 must be revised to delete any provisions for payment on retirement or termination of employment, including for good reason. Otherwise, payment of benefits under the program will constitute nondeductible compensation if it exceeds \$1 million when aggregated with other compensation.

Please contact the [Benefits Law Group](#) if you would like assistance with Section 162(m) compliance or any other benefits issue.

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