



IRS Reverses Position on Whether Certain Incentive Awards are Performance-Based

In a private letter ruling, the IRS ruled that an incentive agreement with an executive that, among other things, provided for payment upon termination by the employer without cause or by the executive with good reason did not provide performance-based compensation. This is opposite to the IRS' position in earlier rulings and means that executive employment agreements and incentive award plans should be reviewed and reevaluated.

Background

Under Section 162(m) of the Internal Revenue Code, a company generally may not deduct compensation paid to certain individuals to the extent it exceeds \$1,000,000, except if it is "payable solely on account of the attainment of one or more performance goals." IRS regulations indicate that if an award is only partially contingent on attaining a performance goal, none of the compensation paid under the award is performance-based. The regulations also indicate that the fact that an award can be paid upon death, disability or change of ownership or control does not mean that the award is not performance-based, but it will not be performance-based if it is actually paid before the performance goal is met.

In two previous private letter rulings, the IRS said that plans under which incentive compensation could be paid upon the executive's termination without cause or for good reason or upon retirement could provide performance-based compensation.

Private Letter Ruling 200804004

In [PLR 200804004](#), the IRS again considered a company's agreement with an executive that allowed payment of performance share or performance unit awards upon termination of employment for other than cause or by the executive for good reason. The compensation would be deemed to be achieved at target and would vest at termination to the extent it would have become vested if employment continued for two years after the termination date.

In analyzing this arrangement, the IRS noted that under its regulations compensation is not performance-based if the facts and circumstances indicate that the employee would receive all or part of the compensation regardless of whether the performance goal is attained. The IRS concluded that because compensation could be paid out

for a reason other than death, disability or change of ownership or control, and could be paid if the performance goal were not met, the agreement did not provide for performance-based compensation. This result would apply regardless of whether the performance goal was met before the compensation was paid out.

Conclusion

This ruling is directly opposite to previous private letter rulings in which the IRS ruled that compensation could be considered performance-based under plans or agreements that allowed payout upon termination of employment without cause or upon retirement even though the performance goal may not have been met.

Although this is a private letter ruling and not to be relied on by other taxpayers, it represents a significant change of position by the IRS. Employers that have plans and agreements with executives that provide for similar payouts upon termination without cause or retirement may want to review and reevaluate them in light of this ruling.

Buck's consultants would be pleased to discuss this ruling and its implications with you.

This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.