Chamberlain Hrdlicka
Attorneys at Law

Contact

Houston
1200 Smith Street, Suite 1400
Houston, Texas 77002-4310
Tel: 713.658.1818
Fax: 713.658.2553

Atlanta
191 Peachtree Street, N.E.,
Forty-Sixth Floor
Atlanta, Georgia 30303
Tel: 404.659.1410
Fax: 404.659.1852

Philadelphia
300 Conshohocken State Road
Suite 570
West Conshohocken, PA 19428
Tel: 610.772.2300
Fax: 610.772.2305

San Antonio
112 East Pecan Street, Suite
1450
San Antonio, Texas 78205
Tel: 210.253.8383
Fax: 210.253.8384

www.chamberlainlaw.com

IRS Adopts Controversial Position on Deductibility of Certain Executive Bonuses

February 2008

In response to a controversial private letter ruling (PLR 200804004), the Internal Revenue Service (IRS) issued Revenue Ruling 2008-13 on February 21, 2008 confirming its much-challenged position that a company can no longer deduct compensation payable upon a termination of employment without cause, a termination for good reason, or an employee's retirement as the IRS will not characterize such compensation as performance based compensation per Section 162(m) of the Internal Revenue Code (IRC).
Recognizing the severe shift from its previous position and analysis, the IRS has created a transition period for the aforementioned ruling.

Revenue Ruling 2008-13

IRC Section 162(m) provides in general that a public company may not deduct compensation paid to its CEO or any of its next four highest-paid officers in excess of $1 million per year. Section 162(m)(4)(c), however, permits a company deduction, irrespective of the 1 million cap, when compensation is "performance based."

Under the Revenue Ruling, the IRS will disallow such an exemption for otherwise qualified performance based compensation if the compensation is payable in whole or in part due to termination without cause, the employee's resignation for good reason, or the employee's retirement. These provisions act to disallow the deduction for this compensation *even if* the performance goals are met.

In reviewing a company's incentive compensation arrangements, one must be particularly mindful of the following provisions:

- Inspect terms that may qualify or implicate a termination without cause or resignation for good reason.
- In employment or severance arrangements, examine provisions that guarantee payments of an employee's fiscal year-end bonus based on performance through the date of termination, or upon attainment of a "target" level.
- Look to the renewal stipulations of employment and severance agreements, as the transition period allotted for in the Revenue applies to arrangements that are in effect as of February 21, 2008, but not to any such agreements that renew or terminate after that date.

Due to recognition by the IRS of the routine reliance of companies on prior contrary private letter rulings, the Revenue provides a transition period for companies to conform to this now very strict view. The new Revenue Ruling will not apply to arrangements that would otherwise qualify for an exemption under Section 162(m) if

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Continued

either:

- The relevant performance period begins on or before January 1, 2009; or
- The compensation is paid pursuant to an employment contract as in effect on February 21, 2008.

Implications of the Ruling

Drafting is of the utmost importance; it matters a great deal how the company writes and designs its severance arrangements. In light of Revenue Ruling 2008-13, and during the transition period, every public company should review its incentive compensation arrangements to ensure that its performance-based exemption will not be inadvertently at risk under the new Revenue Ruling.

Arrangements to keep in mind while assessing conformity under the Revenue Ruling include, but are not be limited to, equity incentive plans, performance-based award arrangements, annual bonus plans, and severance agreements.

Questions About the Impact of Revenue Ruling 2008-13 on Your Incentive Compensation Plans?

Contact the Chamberlain Hrdlicka Employee Benefits Group: Toll-free at 1.800.342.5829, or Jerome M. Harris at 713.654.9651; and Stephen M. Mason at 713.654.9646.