

# THE NONQUALIFIED ADVISOR

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## **New Ruling Disqualifies Certain Performance-Based Pay**

In a surprising private letter ruling (PLR 200804004), which was affirmed in Revenue Notice 2008-13, the IRS reversed a long standing position on the conditions required for “performance-based compensation” under IRC Section 162(m).

Under Section 162(m), publicly held companies cannot deduct compensation paid to “covered” officers, (i.e. the CEO and the next four highest paid officers), in excess of \$1 million in any given year. An exception to the \$1 million limitation is to the extent the compensation is “performance-based compensation.”

For a payment to qualify as “performance-based compensation,” performance conditions must involve pre-established, objective performance goals. Waiver of these performance conditions is only allowed in the event of death, disability or change of control; however, the IRS had previously accepted termination of employment as a condition similar to death, disability or change of control. As a result, employers have been able to pay out performance bonuses and other incentives at termination when performance conditions have not been met.

In PLR 200804004, the IRS re-evaluated its position on permissible waivers and determined that termination of employment was not an acceptable condition for waiver of performance conditions.

Based on the new ruling, employment contracts that waive performance conditions for reasons such as retirement, termination of employment without cause, and resignation for good reason will disqualify the award as “performance-based compensation” under Section 162(m).

In Revenue Notice 2008-13, the IRS clarified that its new position on performance-based pay will be applied prospectively so there are no prior period adjustments; however, employers should review bonus and incentive plans effective after December 31, 2008 to make sure they are compliant with the new ruling.

*Note: The private letter ruling and revenue notice only affect publicly held companies. Highly paid officers of privately held companies are not affected by Section 162(m) or the new ruling.*

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