Performance-Based Compensation?

By Robert W. Wood • Wood & Porter • San Francisco

These days, no one talks much anymore about reasonable compensation, that oxymoronic benchmark for judging deductibility. We are all used to the concept, but we may take it for granted that just about anything seems to be reasonable these days, particularly in the face of outsize compensation packages that seem to be represented in the newspapers nearly every day.

M&A TAX REPORT readers will all remember the enactment of Code Sec. 162(m), which generally limits the deductibility of compensation to $1 million. Fortunately, this section applies only to public companies. It denies a deduction for any compensation paid in excess of $1 million in any tax year to a company's top five employees (as listed in the annual proxy summary compensation table).

Of course, the exception that eats up the rule applies to compensation arrangements that satisfy the not too difficult standards for "qualified performance-based compensation."

Performance Anxiety?

Typically, a compensation committee of the board of directors will establish performance goals that are approved by shareholders. The compensation committee will then have responsibility to ensure that particular executives meet these goals prior to a payment or vesting event. With these relatively simple safeguards, the award under such a compensation system will be deductible, whatever the amount.

The overall question, not unlike the amorphous standards for reasonableness, will simply be whether the performance-based compensation met the criteria, and whether the overall package was reasonable. Since almost by definition, performance-based compensation must be set up in advance by looking at benchmarks, the mere fact that the executive ended up with outsize payments—which might not even be viewed as reasonable in the overall scheme of things—won't seem to matter.

Benign Triggering Events

Notwithstanding the performance-speak that executives and boards are wont to describe, the fact remains that some events may trigger payment outside of the performance-based mantra. The question is how these events should be evaluated for tax purposes. Sensibly, there's some flexibility here.

The IRS regulations under Code Sec. 162(m) indicate that compensation does not lose its performance-based halo if it is payable prior to the attainment of performance goals upon one of three events: death, disability or a change in control. Note, however, that these three blessed circumstances (in which payments can be made under a performance-based plan notwithstanding failure to perform) must still be tested against the $1 million limit.

In other words, if the executive is paid because of death, disability or a change in control, then in that particular year, if the person is within the qualified group of five and his or her compensation has exceeded $1 million for the year, the excess will be nondeductible. By definition in such a case, the pay would be attributable to one of those three events, not to strictly performance-based criteria. But significantly, the mere *presence* of these three conditions in a performance-based plan will not cause the otherwise performance-based program to fail.

Moreover, in addition to the three permitted circumstances, the IRS has been pretty liberal in allowing other events to trigger payment without running afoul of the normal performance-based standards. Suppose, for example, that an executive is involuntarily terminated without cause, or if the executive resigns for good reason. These circumstances, in the IRS's view, are similar to terminations as a result of death, disability or a change in control.

Therefore, such conditions can be a part of a plan without having the plan be treated as something other than performance based.

Watch out

Unfortunately, a recent letter ruling and a recent revenue ruling, LTR 200804004 (Sept. 21, 2007) and Rev. Rul. 2008-13, IRB 2008-10, 1, conclude that an employment contract that calls for accelerated payment of an otherwise performance-based award upon termination without cause or resignation for good reason *still* causes the award to fail the performance-based standards. Why, you might ask?

The answer isn't entirely clear. Interestingly, the IRS says this means that the compensation *might* be paid in circumstances other than the achievement of the performance benchmarks. Of course, this is true; it *might* be. Does that mean that even if the executive achieves all goals and performs in a stellar fashion, compensation in excess of the $1 million threshold will be nondeductible? That's certainly the fear.

The danger of this position is palpable. If only the letter ruling had been issued, this might have been one of those times when practitioners could take some solace in the fact that a letter ruling issued to one taxpayer isn't binding on anyone else. Still, this ruling ought to suggest at least a belt tightening More than this, perhaps it should prompt companies to review every outstanding performance-based compensation package, and to be doubly careful in negotiating and executing new ones. This is of particular importance for those (many) companies that have been used to relying on performance-based standards for deductibility.

Published Authority

On the heels of LTR 200804004, the IRS issued a published ruling, Rev. Rul. 2008-13. That should remove any doubt about this. The published ruling splits the conditions, making clear in two different situations that the answer is the same.

In situation one, a performance plan awards a bonus even if the performance standard is not met, if the employee dies, there is an ownership change, or the employee is terminated without cause or leaves voluntarily for a good reason. In the second situation, the plan calls for the award notwithstanding the failure to meet performance criteria if the employee retires during the year. In both situations, the IRS concludes that the award fails to qualify as performance based.

These provisions taint an otherwise performance-based plan because it is clear from the face of the plan that pay *may* be triggered not by performance but by one of these other conditions. The plan in situation one fails because the involuntary termination could result from poor performance. This fails the "solely" test of Code Sec. 162(m)(4)(C). The plan in situation two fails because voluntary retirement is within the control of the worker, thus failing the requirement that the pay be solely payable on account of reaching the benchmark performance goal. The regulations require qualified performance-based compensation to be paid solely on account of attaining the performance goal and disqualifies payments if the facts and circumstances show that the compensation could be received regardless of the actual attainment of those goals. [*See* Reg. §1.162-27(e)(2).]

Fatal Contract Language

Just to be clear, it is the *presence* of these provisions in a performance-based contract or program that is evidently fatal. Although many plans out there may only allow accelerated (non–performance-based) pay on the big three permitted events (death, disability or a change in control), it has become relatively standard practice for companies to rely on several prior letter rulings, which indicated IRS liberality. Once again, those two previously OK (but now more than suspect) conditions would be an early payout to the executive (without meeting the performance goals) if the executive involuntarily terminated without cause, or if the executive resigned for "good reason."

The IRS suggests that it will not apply the unhappy conclusions in LTR 200804004 or Rev. Rul. 2008-13 to disallow compensation deductions if either the performance period for the compensation begins before January 2, 2009, or if the compensation is paid under an employment contract that is in effect on February 21, 2008. This grandfather clause will keep some people out of trouble.

What's Reasonable?

Outside Code Sec. 162(m), what is reasonable is still an intensely factual determination, and almost exclusively the province of closely held companies. Not many cases actually make it through the court system on this point. In *LabelGraphics, Inc.*, CA-9, 2000-2 USTC ¶50,648, 221 F3d 1091 (2000), a corporation that produced pressure sensitive identification materials such as labels and graphic overlays. The company claimed a deduction for $878,913 in compensation for one year paid to the president and sole shareholder, Martin. The IRS sought to cut this amount by more than half, denying the company a big part of its deduction.

The Tax Court held that the corporation could deduct $406,000 of the $878,900 it paid to Martin, concluding that the balance was not reasonable. As with all such cases, the Tax Court had to go through the analysis of the skills of Martin and his relationship with the business. To some extent, a particularly good year can be harmful. The court was struck by the fact that the $722,900 paid to Martin was nearly three times the amount of Martin's largest prior bonus. LabelGraphics acknowledged that this bonus was unusually high. In what was perhaps the largest failing LabelGraphics made in its case, it failed to prove that any portion of this extraordinary year was attributable to prior years' inadequate compensation. Inadequate compensation for a prior year is often the lynchpin of any claim for reasonable compensation.

One of the other important standards in a reasonable compensation case is what independent investors would do. The Tax Court found that because of the 1990 bonus paid to Martin, LabelGraphics suffered a loss and had a negative 6.19 percent return on equity for 1990. The court posited that an independent investor would not be satisfied with that negative return on equity, especially when the bonus equaled about 45 percent of the investor's equity in the company.

When the case reached the Ninth Circuit, the circuit court found that the Tax Court did not clearly err in determining the amount of reasonable compensation. The court used a two-pronged test to determine if the compensation was actually compensation or was something else:

- Is the amount reasonable?
- Is the payment purely for services?

Here, given Martin's role in the company, a comparison of his salary with other companies' salaries for similar services, the character and condition of the company, and the potential conflicts of interest, the circuit court found that the Tax Court did not err in its determination of what constituted compensation.

Note that one of the most important elements to remember is the doctrine that allows past compensation to be taken into account, with no time limit. It may be possible to show that a founder or other key person was paid inadequately for the last 20 years, and that a large payment makes up for this.

Independent Investor Test

Some courts have determined that corporate profits (after deduction for salaries to shareholder-employees) should be considered in determining whether compensation is "reasonable." One of the best-known cases is *Elliotts, Inc.*, CA-9, 83-2 USTC ¶9610, 716 F2d 1241 (1983). There, the court stated that if the "company's earnings on equity remain at a level that would satisfy an independent investor, there is a strong indication that management is providing compensable services and the profits are not being siphoned out of the company disguised as salary." [*Id.*, at 1247.]

Applying the independent investor test is essentially a matter of considering the total return to the investor, including dividends, stock appreciation and corporate earnings. That means there can be some flexibility. [*See Home Interiors & Gifts, Inc.*, 73 TC 1142, Dec. 36,842 (1980).] Of course, the IRS takes the position that a low rate of return on invested capital may support an inference that payments to shareholders constitute a distribution of profits. The IRS has generally been required to show that this low rate of return during the years in question was caused by unreasonable compensation, and not other reasons, such as fluctuating business cycles. [For example, *see Bringwald, Inc.*, CtCls, 64-2 USTC ¶9638, 334 F2d 639 (1964).]

It is unlikely that the reasonable compensation doctrine will pass from our scene, at least under our current tax system. Practitioners may only occasionally have to confront these issues, and they are decidedly creatures of the private company rather than public company world. Still, the topic of just what is reasonable is still very much alive. And, particularly when the compensation in question has been paid either before or after a takeover, other considerations (capitalization concerns and/or golden parachute concerns) can put a special spin on this still vital field.

Code Sec. 409A Problems Too?

Code Sec. 409A was enacted by the American Jobs Creation Act of 2004 (P.L. 108-357). It is now fairly well ingrained in the psyche of tax professionals, and even a fair number of executives. Code Sec. 409A restricts deferred compensation arrangements in a significant fashion. In the context of performance-based compensation, Code Sec. 409A generally allows an executive to make an election to defer a performance bonus, as late as six months prior to the end of the particular performance period.

If the executive is entitled to receive the bonus *regardless* of performance, though, what gives? For example, suppose an executive's employment is involuntarily terminated (or that he quits for good reason) during the performance period. The normal deferral election rules should apply.

Under Code Sec. 409A, these rules require that the election must be made in the calendar year prior to the beginning of the performance period. In other words, there is much, much flexibility about deciding when and whether to defer.

Of course, unlike the Code Sec. 162(m) rules (which apply only to public companies), Code Sec. 409A applies to everyone, private and public company alike.

Be careful out there!