



IRS 162(m) Ruling Requires Review of Incentive Pay Arrangements

John J. Battaglia

In **Revenue Ruling 2008-13**, issued on February 21, 2008, the IRS held that incentive pay cannot qualify as performance-based compensation under section 162(m) of the Internal Revenue Code if all or a portion can be paid upon the executive's involuntary termination without cause, voluntary termination for good reason or retirement, even if the executive continues in service and the incentive is actually paid upon attainment of the pre-stated performance goal.

The new Revenue Ruling confirms the IRS's holding in Private Letter Ruling 200804004, released on January 25, 2008, which reversed the IRS's long-standing position on this issue. To the relief of many public companies that had structured their incentive plans and awards in reliance on the IRS's prior position, Revenue Ruling 2008-13 will be given prospective application only, as described below.

Background

Section 162(m) imposes a \$1 million limit on the allowable deduction for compensation paid to any "covered employee."¹ Amounts that qualify as "performance-based compensation" are not counted towards the \$1 million limit. To qualify as performance-based compensation, section 162(m) requires that the compensation be payable "solely on account of the attainment of one or more performance goals." Treasury regulations under section 162(m) provide that compensation does not meet this basic requirement if the covered employee could receive all or part of the compensation without attaining the performance goals.

The regulations further provide, however, that compensation does not fail to be qualified performance-based compensation merely because the plan or award permits the compensation to be paid upon the covered employee's death or disability, or upon a

change of ownership or control of the company, although the compensation actually paid on account of those events prior to the attainment of the performance goal would not be qualified performance-based compensation.

PLR 200804004

On January 25, 2008, the IRS released Private Letter Ruling 200804004, which held that if an employment agreement provides for the automatic payment of performance awards at the "target" level when employment is terminated without cause or for good reason, the performance award does not qualify as "performance-based compensation" under section 162(m) because it is not payable "solely on account of the attainment of one or more performance goals." According to the ruling, the performance award in question would be subject to the \$1 million deduction limit under section 162(m), even if employment was not terminated and the award was actually paid upon attainment of the pre-stated performance goal.

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This ruling reflected a reversal of the IRS's position stated in two prior private letter rulings (PLR 199949014 and PLR 200613012). In the 1999 ruling, the IRS stated that compensation paid under a performance-based stock award plan would not fail to qualify for deduction as performance-based compensation under section 162(m) even if the plan provided for accelerated stock vesting upon the employee's termination without cause or for good reason. The IRS reasoned that such "involuntary terminations" were substantially similar to terminations due to death, disability or a change of control so as to be included under the exception in the regulations for accelerated payments on account of those events. The 2006 ruling further extended the exception to include incentive payments made early on account of the executive's retirement.

John J. Battaglia is counsel in the New York office of Pillsbury Winthrop Shaw Pittman LLP. This article can also be found on the world wide web as part of the Pillsbury Winthrop Shaw Pittman LLP Tax Page.

¹ Covered employees include a public company's chief executive officer and its three highest-paid officers other than the CEO, but excluding the chief financial officer.

In PLR 200804004, however, the IRS interpreted the “death, disability and change in control” exception in the regulations much more literally, holding that an award that could become payable before attainment of the performance goals due to the occurrence of any event other than death, disability or a change of control does not qualify as performance-based compensation for purposes of section 162(m). IRS private letter rulings are binding only on the companies that requested the rulings. But by creating uncertainty regarding the deductibility of prior and pending incentive pay, the new ruling raised tax and financial accounting concerns among public companies that relied on the earlier IRS rulings.

Revenue Ruling 2008-13

Revenue Ruling 2008-13, unlike PLR 200804004, applies to all public companies. The new Revenue Ruling confirms the IRS’s holding in PLR 200804004 that an incentive award that permits payment of all or part of the award upon an executive’s involuntary termination without cause or termination for good reason will cause the award to fail to qualify as section 162(m) performance-based compensation. The IRS reasoned that such an award is not payable “solely upon the attainment of the performance goals,” as required by the regulations, because these types of termination may arise as a result of the executive’s poor performance and a failure to meet the performance goal. The Revenue Ruling also expanded this holding to incentive awards that are paid early in connection with the executive’s retirement. According to the IRS, the incentive award in this case is not payable solely on attainment of the performance

goals because “retirement generally is a voluntary action within the control of the covered employee.”

Transition Relief; Prospective Application

In view of the fact that, in reliance on the IRS’ prior rulings, many existing plans and employment agreements provide for accelerated payments on involuntary terminations or retirement, the IRS has limited the application of Revenue Ruling 2008-13 to future arrangements only. Under this transition relief, the IRS will not apply the holdings in Revenue Ruling 2008-13 to disallow a deduction for any compensation that otherwise satisfies the requirements for performance-based compensation under section 162(m), except for permitting all or a portion of the compensation to be paid upon the executive’s involuntary termination without cause, good reason termination or retirement, if either (i) the performance period begins on or before January 1, 2009 or (ii) the compensation is paid pursuant to an employment agreement as in effect (excluding renewals) on February 21, 2008.

Employment agreements in effect on February 21, 2008 will no longer be covered by this transition relief upon their renewal (including automatic renewals). Thus, public companies should review their executive employment agreements prior to renewal to determine if any modifications are needed to ensure deductibility of incentive pay under section 162(m). In the longer term, public companies will need to consider the new deductibility limitations when structuring new incentive pay arrangements with performance periods beginning after January 1, 2009.

Supreme Court Decision May Spur Individual and Class Actions Against ERISA Fiduciaries for Defined Contribution Plans

Frederick A. Brodie • Susan P. Serota • Bruce A. Ericson • Elizabeth Husa

The U.S. Supreme Court has opened the door to more claims by participants in 401(k) plans who allege that the plan fiduciaries' breach of their duties under the Employment Retirement Income Security Act of 1974 ("ERISA") reduced the value of the participants' individual accounts. Without a dissent, the Court held that ERISA allows participants in a defined contribution plan to recover from plan fiduciaries for losses in their individual plan accounts, when those losses are caused by fiduciary misconduct. *LaRue v. DeWolff, Boberg, & Assocs.*, 128 S.Ct. 1020 (Feb. 20, 2008).

Although it did not address such claims directly, the decision will be viewed by plaintiffs' lawyers as lending legal foundation to the numerous class actions that have been brought against troubled companies based on the investment of 401(k) plan assets in company stock. As a result of the Supreme Court's decision, therefore, one can anticipate more class actions by 401(k) participants, as well as lawsuits by individual defined contribution plan participants whose enrollment or investment elections were mishandled by the plan administrators.

Recovery Available For Losses to Individual's Account in a Defined Contribution Plan

The Supreme Court observed in *LaRue* that the "landscape of employee benefit plans" has changed over the last two decades. While the typical form of retirement plan used to be the traditional defined benefit plan, in which participants were paid a pension or similar fixed benefit based on a formula, today "[d]efined contribution plans dominate the retirement plan scene." A defined contribution plan provides varying returns based upon how much participants elect to contribute and how participants' contributions are invested.

Prior to *LaRue*, some courts had concluded that defined contribution plan participants could not seek relief under ERISA's fiduciary provisions for losses in their individual accounts. Those courts relied on the text of ERISA § 409, 29 U.S.C. § 1109, which provides that fiduciaries "to a plan," if found liable for breach of their duties, must make good any losses "to such plan" and restore lost profits "to such plan." In *Massachusetts Mutual Life Insurance Co. v. Russell*, 473 U.S. 134, 142 (1985), the Supreme Court had remarked, in the context of a defined benefit plan, that ERISA's framers

"were primarily concerned with the possible misuse of plan assets, and with remedies that would protect the entire plan, rather than with the rights of an individual beneficiary."

In *LaRue*, a participant in a defined contribution plan claimed that he had directed the plan sponsor to make certain changes to his investments, but that his directions were never carried out. The participant sued his former employer, DeWolff, Boberg, & Associates, Inc. ("DeWolff"), as well as the ERISA-regulated 401(k) defined contribution plan that DeWolff administered, to recover approximately \$150,000, which he claimed was the amount by which the omission had "depleted" his interest in the Plan.

The District Court granted DeWolff's motion for judgment on the pleadings and the U.S. Court of Appeals for the Fourth Circuit affirmed. The Fourth Circuit rejected the participant's claim that he had a cognizable claim under ERISA § 502(a)(2)—which authorizes "appropriate relief under [ERISA] § 409"—because that section "provides remedies only for entire plans, not for individuals." *LaRue v. DeWolff, Boberg, & Assocs.*, 450 F.3d 570, 572 (4th Cir. 2006).

The U.S. Supreme Court reversed. Unanimously, the Justices concluded that a participant in a defined contribution plan could sue under ERISA § 502(a)(2) to recover losses sustained in his individual plan account.

Defined Benefit, Defined Contribution Plan Structures Distinguished

The five-justice majority opinion, written by Justice John Paul Stevens, focused on the distinction between defined benefit and defined contribution plans to support the plaintiff's claim for relief. The majority contrasted the plaintiff's claim with the one in *Russell*, where a participant in a disability plan had sought consequential damages arising from a delay

Frederick A. Brodie (New York), *Susan P. Serota* (New York) and *Bruce A. Ericson* (San Francisco) are partners and *Elizabeth Husa* (New York) is an associate with Pillsbury Winthrop Shaw Pittman LLP. This article can also be found on the world wide web as part of the *Pillsbury Winthrop Shaw Pittman LLP Tax Page*.

in processing her contractually-determined benefit. “Unlike the defined contribution plan in this case,” the majority explained, “the disability plan at issue in *Russell* did not have individual accounts; it paid a fixed benefit based on a percentage of the employee’s salary.” While the petitioner in *Russell* received the full amount of the fund assets to which she was contractually entitled, the petitioner in *LaRue* alleged that he had received less than his contractually determined share of the fund assets due to the plan administrators’ breach of fiduciary duty.

“For defined contribution plans,” the majority reasoned, “fiduciary misconduct need not threaten the solvency of the entire plan to reduce benefits below the amount that participants would otherwise receive. Whether a fiduciary breach diminishes plan assets payable to all participants and beneficiaries, or only to persons tied to particular individual accounts, it creates the kind of harms that concerned the draftsmen of [ERISA] § 409.”

In a separate concurrence, Justice Clarence Thomas, joined by Justice Antonin Scalia, explained further that defined contribution plans are composed of a number of individual accounts. “[W]hen a defined contribution plan sustains losses, those losses are reflected in the balances of the plan accounts of the affected participants, and a recovery of those losses would be allocated to one or more individual accounts,” Justice Thomas noted. “On their face,” he wrote, “[ERISA] §§ 409(a) and 502(a)(2) permit recovery of *all* plan losses caused by a fiduciary breach,” including those felt by the holders of individual accounts.

In another separate concurrence, Chief Justice John G. Roberts, Jr., joined by Justice Anthony Kennedy, observed that ERISA § 502(a)(1)(B), which allows participants to “recover benefits due ... under the terms of [the] plan,” may also provide relief in this situation. Identifying a possible defense to fiduciary claims for lost benefits, Chief Justice Roberts noted that the *LaRue* Court had not considered whether the possible availability of relief under § 502(a)(1)(B) might change the result.

Plan Fiduciaries Should Prepare for More Lawsuits

After *LaRue*, ERISA fiduciaries should anticipate expanded claims for liability under ERISA. Class action plaintiffs will likely argue that *LaRue* provides a legal basis for recovering losses sustained in individual 401(k) plan accounts due to plan investments in company stock. The complaints in such cases typically allege that the plan fiduciaries, who often include company insiders, knew adverse information about the company’s prospects

yet breached their fiduciary duties by continuing to allow the purchase of company stock with plan funds. The fiduciary obligations at issue in those cases include the duty to act “solely in the interest of the participants and beneficiaries,” the duty to administer the plan with the diligence and care expected of “a prudent man acting in a like capacity and familiar with such matters,” and the duty to diversify plan assets so as to minimize the risk of large losses. See ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1).

Additionally, fiduciaries should expect more individual claims for breach of fiduciary duty based on plan processing errors. *LaRue* will likely be viewed as providing authority for such claims. The Court, however, noted that it had not decided whether the plaintiff was required to “exhaust” the plan’s administrative remedies before suing for breach of fiduciary duty. Chief Justice Roberts’ concurrence spoke to the issue at greater length, explaining that courts have disagreed over whether plaintiffs may “recast” as claims for breach of fiduciary duty “what are in essence plan-derived benefit claims that should be brought under [ERISA] § 502(a)(1)(B).” If such a claim were brought under section 502(a)(1)(B), Chief Justice Roberts observed, it would be subject to the “safeguard ... recognized by almost all the Courts of Appeals ... that a participant exhaust the administrative remedies mandated by ERISA ... before filing suit.” The plan administrator’s decisions on such matters typically are reviewed only for abuse of discretion.

LaRue has also clarified that the pool of potential plaintiffs is not limited to current participants. Previously, some federal courts had precluded former participants, who had liquidated their plan accounts, from suing for earlier losses in those accounts. In a footnote, the Supreme Court observed that *LaRue* did not become moot just because the plaintiff was no longer a plan participant: a plan “participant” under ERISA may include “a former employee with a colorable claim for benefits.”

How Should Plan Participants and Plan Fiduciaries Respond to *LaRue*?

L*aRue* recognizes and endorses current theories in ERISA litigation, while leaving the viability of defenses to those theories uncertain. The result may well be more litigation accusing plan fiduciaries of breaching their fiduciary duties.

The ultimate recoveries in 401(k) fiduciary cases may be significant. As the Supreme Court recognized in a footnote, ERISA § 502(a)(2) “encompasses appropriate claims for ‘lost profits’” resulting from a fiduciary breach.

In other words, the plan fiduciaries may be required to restore a plaintiff to the situation in which he would have been, had no breach of duty occurred.

Consequently, following *LaRue*, plan sponsors and fiduciaries may wish to consider the following steps, among others:

- Ensure that the plan has a working administrative process that complies with applicable regulations and has been disclosed to plan participants in appropriate detail.
- Ensure that the plan administrative process extends to fiduciary claims (although federal courts may not respect such provisions in some cases).
- Confirm that the plan administrator has been granted discretion in interpreting the plan and in making findings of fact, so that the administrative decisions are protected by the liberal “abuse of discretion” standard.
- Review the plan’s compliance with ERISA § 404(c) and related regulations, which protect fiduciaries from liability for the investment choices made by participants in defined contribution plans.
- Review the plan’s policy on investments in company stock, and consider whether any changes are appropriate.
- Review the plan’s fiduciary insurance, if any, and determine whether the plan and its fiduciaries are adequately covered.

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