CLEARY GOTTLIEB Alert Memo

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New FASB Revenue Recognition Standards May Affect 162(m) Bonus Plans

On September 23, 2009, the Financial Accounting Standards Board (FASB) ratified new standards for recognizing revenue from bundled sales of products and services.[1] Companies are required to adopt these new standards for arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption is also permitted. Under the new standards, companies may see an increase in revenue in the periods following adoption as compared to recent prior periods, as portions of the income from bundled sales may be recognized earlier (in some cases, significantly earlier) than would have been permitted under the prior accounting standards. Companies that maintain performance-based incentive compensation arrangements based in whole or in part on revenues related to bundled sales may wish to adjust the relevant performance targets for periods including or commencing after the date they adopt the new standards to reflect the accounting changes. However, for incentive arrangements that are intended to comply with Section 162(m) of the Internal Revenue Code, care should be taken to avoid any adjustment that may adversely affect an arrangement's compliance with that section's requirements.

In general, compensation in excess of $1,000,000 per year paid to each of a public corporation's "covered employees," which includes the company's chief executive officer and up to three of its other most highly paid executive officers serving as such at the end of the taxable year (other than its chief financial officer) named in the Summary Compensation Table of the corporation's proxy statement, may not be deducted as a business expense unless it meets the requirements for performance-based compensation under Section 162(m). In order to qualify as performance-based compensation, the performance goals of a bonus plan must be objective and pre-established, precluding any discretion to increase the amount of the incentive compensation, and generally precluding the ability to change formulas or performance targets during a performance period.[2]

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1 Contained in Accounting Standards Update No. 2009-13, Revenue Recognition (Topic 605): *Multiple-Deliverable Revenue Arrangements – A Consensus of the FASB Emerging Issues Task Force*; Accounting Standards Update No. 2009-14, Software (Topic 985): *Certain Revenue Arrangements That Include Software Elements – A Consensus of the FASB Emerging Issues Task Force*.

2 Treas.Reg. § 1.162-27(e)(2)(iii).

The regulations promulgated under Section 162(m) provide that certain limited types of adjustments to performance goals will not constitute an impermissible exercise of discretion or be deemed to be an impermissible amendment of a pre-established formula. An example included under Treasury Regulation Section 1.162-27(e)(2)(vii) illustrates one such adjustment. It states that when a plan provides that a bonus will be paid to a covered employee if there is a 10% increase in earnings per share during the performance period, calculated without regard to any change in accounting standards, it is not an impermissible exercise of discretion to adjust the corporation's earnings per share under the plan to factor out the change in standards.[3] By implication, it would seem that if a plan provides that performance targets will be adjusted to reflect changes in accounting standards, the company could so adjust its targets without violating Section 162(m)'s requirements of objectivity and pre-established goals, although this has not been directly addressed in the regulations, private letter rulings or other guidance issued by the Internal Revenue Service ("IRS"). Many bonus plans explicitly provide for such adjustments.

In the case of a bonus plan that does not specifically provide for adjustment for changes in accounting standards during a performance period, it is less clear that making such adjustments would be allowed. The IRS issued a private letter ruling in 2000 that states that the example in the regulations noted above creates a negative implication that "if a provision in the plan does not call for an adjustment in the performance goals or a period in the case of an unforeseen event, such an adjustment would be an exercise of impermissible discretion."[4] In the ruling, it appears that the taxpayer changed fiscal years, resulting in a shortened fiscal year, after its plan's performance goals had been set for that year. The company appears to have sought to adjust the formula under the plan so that a proportional fraction of the amounts that would otherwise have been paid for the full fiscal year would be paid following the conclusion of the shortened fiscal year, subject to repayment if the original performance targets for the full, original fiscal year are not attained. The ruling concludes that such a change would not disqualify the payout as performance-based compensation. We note that this conclusion could have been based on the determination that the change was an exercise of negative discretion that is permissible under the rules without the need for explicit plan language (see below), but that interpretation is not perfectly clear from the

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[3] Treas. Reg. § 1.162-27(e)(2)(vii), Example 13.

[4] P.L.R. 200044007 (Nov. 16, 2000). Interestingly, the formulation quoted above creates its own implication – that if a provision in the plan does call for an adjustment in the performance goals or a period in the case of an unforeseen event, such an adjustment would not be an exercise of impermissible discretion. That rule arguably extends the rule illustrated by Example 13 insofar as Example 13 involved a formula that required accounting changes to be ignored whereas the quoted language above presumes that accounting changes will be taken into account and performance goals or periods adjusted. The PLR, therefore, supports our conclusion concerning the ability to adjust performance targets and formulas if the plan so provides.

ruling. Other than the language quoted above, the ruling does not explicitly address the issue of adjusting performance targets.[5]

If a performance-based incentive compensation arrangement does not explicitly provide for the ability to adjust performance targets to reflect changes in accounting standards, there is another way in which a company might adjust payments to reflect such changes while preserving the arrangement's status under Section 162(m). Section 162(m) does not prohibit the exercise of negative discretion to pay smaller amounts than would otherwise have been called for under a plan's formula based on the level of achievement attained (although whether such negative discretion is permissible as a matter of contract in any particular case will depend on the terms of the applicable plan, contract or arrangement).[6] Accordingly, if the revisions to the accounting standards accelerate revenue recognition for a corporation during a performance period for which an objective formula was pre-established, which acceleration leads to a larger incentive payment than would have been payable had the accounting standards not changed, then negative discretion might be able to be used to adjust the payout to eliminate the effect of the change in accounting standards.

With respect to future performance periods, in order to preserve maximum flexibility to respond to changes in accounting standards and other unforeseen events, companies should therefore generally include language in their incentive plans that permits adjustments to performance goals and formulas if accounting changes occur during a performance period.[7]

In addition to the potential issue raised under Section 162(m) by the new accounting standards, we note a second, unrelated issue that has year-end 2009 implications. A

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5 The company applying for the private letter ruling also sought a determination of whether its officers would be "covered employees" for purposes of Section 162(m) for the short fiscal year as no proxy statement was required to be filed.

6 It seems clear that a plan is not required to explicitly provide for the exercise of negative discretion in order to comply with the requirements for treatment of compensation as performance based. Treas. Reg. § 1.167-27(e)(2)(iii)(A) provides that "the terms of an objective formula or standard must preclude discretion to increase the amount of compensation payable that would otherwise be due upon attainment of the goal. A performance goal is not discretionary for purposes of this paragraph (e)(2)(iii) merely because the compensation committee reduces or eliminates the compensation or other economic benefit that was due upon attainment of the goal." However, the ability to exercise negative discretion ordinarily must be preserved as a contractual matter between the employer and the employee.

7 The regulations issued under Section 162(m) require that the material terms of the performance goal under which the compensation would be paid must be disclosed to and approved by shareholders. Treas. Reg. § 1.167-27(e)(4)(i). No additional disclosure or approval of the performance goals is required unless the material terms of the goals are changed. Treas. Reg. § 1.167-27(e)(4)(vii). The addition of the ability to adjust performance targets to reflect changes in accounting standards should generally not be deemed to be a change in the material terms of the goals affecting the validity of prior shareholder approval.

Revenue Ruling issued by the IRS in 2008 stated that if an employment agreement provides for the automatic payment of performance awards at target levels if the executive's employment is terminated without cause, for good reason or by reason of retirement during a performance period, the award does not qualify under Section 162(m) as "performance-based compensation," reversing an interpretive position that was taken in a small number of previously issued private letter rulings.[8] The Revenue Ruling applies to performance periods beginning after January 1, 2009. Companies that commence new performance periods on January 1, 2010 should ensure compliance with the Revenue Ruling.

Please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under Employee Benefits in the Practices section of our website (http://www.clearygottlieb.com) if you have any questions.

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[8] Rev. Rul. 2008-13, 2/21/2008. For more information, please see the CGSH Alert Memorandum entitled "New Revenue Ruling Regarding Section 162(m)" issued February 22, 2008 (available here).

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