

## *Client Alert*

# And Then There Were Four...

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### *Notice 2007-49 Clarifies that the IRS will Exclude CFOs from Being "Covered Employees" for purposes of Code Section 162(m)*

On June 5<sup>th</sup>, the IRS issued Notice 2007-49 (Notice) which clarifies issues that had arisen under Internal Revenue Code (Code) Section 162(m) as a result of the recent changes in the disclosure rules regarding which officers must be included in the required compensation disclosures, typically appearing in public companies' proxies.

#### *Covered Employees Under Section 162(m)*

Under Code Section 162(m)(3), the following individuals are "Covered Employees" and therefore their compensation is subject to Section 162(m)'s \$1 million deduction limitation unless it qualifies for certain exemptions, e.g., the performance-based compensation exemption:

- The CEO or an individual acting in such capacity as of the close of the taxable year, and
- The four (4) highest compensated officers as of the close of the taxable year (other than the CEO), who are required to be reported in accordance with the compensation disclosure rules as a result of their compensation.

Treas. Reg. §1.162-27(c)(2)(ii) provides that whether an individual is the CEO or among the four highest compensated officers (other than the CEO) is determined pursuant to the compensation disclosure rules for securities law purposes.

#### *The Old Compensation Disclosure Rules*

Under the old compensation disclosure rules, the following individuals were the Named Executive Officers (NEOs) who had to be included in the compensation disclosures of a public company (other than a Small Business Issuer which had fewer individuals):

- The CEO and any individual acting as CEO during the taxable year,
- The other four (4) highest paid executives (other than the CEO), if their total base salary plus bonus was greater than \$100,000 per year, and they were employed as executive officers as of the end of the last fiscal year, and
- Up to two (2) additional individuals who would have been among the top four highest paid executives but for the fact that they were not serving as executive officers as of the end of the last fiscal year.

#### *The New Compensation Disclosure Rules*

The new compensation disclosure rules adopted by the U.S. Securities and Exchange Commission defines NEOs as follows:

- The Principal Executive Officer or "PEO" (generally, the CEO) or anyone acting in such capacity during the last fiscal year,
- The Principal Financial Officer or "PFO" (generally, the CFO) or anyone acting in such capacity during the last fiscal year,
- The top three (3) highest paid executive officers (other than the PEO and PFO) who were serving as executive officers at the end of the last fiscal year, and

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- Up to two (2) additional individuals who would have been among the top three highest paid executives but for the fact that they were not serving as executive officers as of the end of the last fiscal year.

So under the new compensation disclosure rules, the PFO joins the PEO as an officer whose compensation always needs to be disclosed (something the definition of “Covered Employee” in Code Section 162(m)(3) does not anticipate or contemplate).

### *The Issue*

Therefore, once the compensation disclosure rules were changed, the meaning of “Covered Employee” for purposes of Section 162(m) was less than clear because the definition of NEO, on which the definition of “Covered Employee” was based, had changed.

### *The IRS Clarification*

The IRS therefore issued Notice 2007-49 to clarify how the IRS would interpret the definition of “Covered Employee” in light of the new compensation disclosure rules. Given that the Treasury and the IRS lack authority to amend the U.S. Code (that being the purview of Congress) or the compensation disclosure rules, the IRS had no choice but to apply the definition of Covered Employee as it currently exists to the new (changed) compensation disclosure rules’ definition of NEO.

As a result, the IRS concluded that a PFO will **not** be a Covered Employee, while the following executives will be Covered Employees:

- PEO or anyone acting in that capacity
- The 3 highest compensated officers for the taxable year (other than the PEO and PFO) who were serving as executive officers as of the end of the taxable year.

The Notice actually leaves open the possibility that if a PFO holds another officer position and that position is required to be disclosed as an NEO, then the PFO could be treated as a Covered Employee based on that other position. However, we think it is likely that CFOs with multiple positions and/or titles will seek to clarify their titles so that they only include the title CFO and no others to guard against this possibility.

### *Will Congress Act?*

All of this of course presumes that Congress sits idly by and permits the IRS clarification to stand. Frankly, we believe that is unlikely given the current sociopolitical environment. As a result, we encourage companies to anticipate that Congress will move to enact its own “clarification,” which will likely restore the prior relationship between NEOs under the compensation disclosure rules and Covered Employees for purposes of Code Section 162(m). To the extent that Congress does decide to revise the definition of “Covered Employee” we suggest it simply reference the section in the compensation disclosure rules, as exists from time to time, that defines the NEOs so as to avoid any future issues as well.

### *Practical Advice*

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- Continue to take the steps necessary to qualify the PFO’s compensation for the performance-based compensation exemption under Code Section 162(m). If the PFO continues to not be a Covered Employee, there is no harm in doing so. But, doing so will enable the PFO’s compensation to continue to be deducted by the Company if the PFO takes another NEO position, e.g., the PEO position.
- Watch out for Congressional action on this issue. We’ll let you know if Congress decides to issue its own clarification and how that will impact things under Code Section 162(m).

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