IRS Narrows Definition of "Covered Employees" for Purposes of the $1 Million Limitation on Deducting Executive Compensation

This week the IRS issued guidance on identifying "covered employees" for purposes of Section 162(m) of the Internal Revenue Code in response to the SEC's recent amendments to its executive compensation disclosure rules.

This Update summarizes the key highlights from this IRS guidance and offers practical advice.

Background on Section 162(m)

Section 162(m) generally provides that a publicly held company cannot deduct applicable compensation with respect to any "covered employee" to the extent that the amount of that employee's compensation for the taxable year exceeds $1 million (subject to some exceptions, such as for "performance-based compensation").

Amended SEC Executive Compensation Disclosure Rules Created Disconnect. The existing definition of "covered employee" under Section 162(m) generally provides that an employee will be a "covered employee" with respect to a taxable year if, on the last day of the taxable year, the employee is:

- the chief executive officer (or an individual acting in that capacity) or
- an employee whose compensation is required to be reported to shareholders under the executive compensation disclosure rules of the Securities Exchange Act of 1934 by reason of being among the four highest compensated officers (other than the chief executive officer).

Under the SEC's recent amendments to its executive compensation disclosure rules, each public company must disclose compensation for its principal executive officer and its principal financial officer, without regard to their relative compensation, and for its three most highly compensated executive officers, other than the principal executive officer and the principal financial officer (instead of for its chief executive officer and its four most highly compensated executive officers, other than the chief executive officer, as was required under the prior SEC executive compensation disclosure rules). This change in the SEC's executive compensation disclosure rules created a disconnect with the existing Section 162(m) definition of "covered employee." To date, Congress has not amended Section 162(m) to resolve the disconnect.

IRS Guidance Clarifies Definition of "Covered Employee." To address the disconnect created by the SEC's new executive compensation disclosure rules, the IRS has issued guidance clarifying the meaning of "covered employees" for purposes of Section 162(m). Specifically, Notice 2007-49 provides that the IRS will interpret the term "covered employee" as any employee if, as of the close of the taxable year:

- the employee is the principal executive officer as defined by the SEC's amended executive compensation disclosure rules (or an individual acting in that capacity) or
- the total compensation of the employee for that taxable year is required to be reported to shareholders under the SEC's amended executive compensation disclosure rules by reason of the employee being among the three highest compensated officers for the taxable year, other than the principal executive officer or the principal financial officer (or an individual acting in that capacity).
IRS Interpretation of "Covered Employee" Definition Excludes Principal Financial Officer. Notice 2007-49 specifically confirms the IRS position that it will not interpret the term "covered employee" under Section 162(m) to include a company's principal financial officer (or an individual acting in that capacity) for whom disclosure is required under the SEC's new executive compensation disclosure rules. Accordingly, even if a company's principal financial officer would be among its three highest compensated officers, the principal financial officer will not be a "covered employee" for purposes of the Section 162(m) limitation on executive compensation deductions.

Stay Tuned – Congress May Eventually Expand Definition of "Covered Employee." The $1 million limitation on deductions for executive compensation under Section 162(m) applies to a company in the taxable year in which it would otherwise be allowed to deduct the compensation, which means that, irrespective of the IRS guidance provided in Notice 2007-49, congressional amendments to the definition of "covered employee" eventually may expand the employees who will be considered "covered employees." As companies monitor executive officer compensation for purposes of determining the executive officers for whom they may have to disclose compensation information in future years, they should also keep in mind which employees could potentially become covered employees for purposes of Section 162(m).

Additional Information

This Update is only intended to provide a general summary of Notice 2007-49. You can read the full text of Notice 2007-49 at http://www.irs.gov/pub/irs-drop/n-07-49.pdf. You can find discussions of other recent cases, laws, regulations and rule proposals of interest to public companies on our website.

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