

## Legal Updates & News

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#### IRS Issues Guidance on Identifying Covered Employees under Section 162(m)

June 2007

On June 4, 2007, the IRS issued Notice 2007-49 (the "Notice"), which provides guidance on identifying covered employees for the purpose of Section 162(m) of the Internal Revenue Code of 1986, as amended (the "Code").

Generally, in the case of any publicly-held corporation, compensation for personal services by covered employees in excess of \$1 million is not deductible, unless certain requirements are met as set forth under Code Section 162(m).

Section 162(m) of the Code defines a "covered employee" as any employee of a corporation, as of the close of the taxable year, who is the chief executive officer or who is acting in such capacity or any employee whose total compensation is required to be reported to shareholders in the annual proxy statement under the Securities Exchange Act of 1934 (the "Exchange Act") because such employee is among the four highest compensated officers for the taxable year (other than the chief executive officer).

The regulations under Code Section 162(m) provide that whether an employee is the chief executive officer or among the four highest compensated officers, and who is, therefore, a covered employee, is determined pursuant to the executive compensation disclosure rules under the Exchange Act.

The rules under the Exchange Act were recently amended to change the composition of the executive officers that must be disclosed to shareholders. Under the new rules, named executive officers consist of (i) a corporation's principal executive officer or anyone acting in a similar capacity during the last completed fiscal year, regardless of compensation; (ii) a corporation's principal financial officer or anyone acting in a similar capacity during the last completed fiscal year, regardless of compensation; and (iii) a corporation's three most highly compensated executive officers, other than the principal executive officer and the principal financial officer, who were serving as executive officers at the end of the last completed fiscal year.

The definition of "covered employees" had previously mirrored the definition of named executive officers under the old Exchange Act rules. However, the Exchange Act rules no longer track the definition of "covered employees" under Code Section 162(m).

Therefore, the IRS guidance states that the IRS will now interpret the term "covered employee" to mean any employee of the taxpayer if, at the close of the taxable year, such employee is the principal executive officer (as provided in the amended Exchange Act rules) or acts in such capacity, or if the total compensation of such employee for that taxable year is required to be disclosed under the Exchange Act by reason of such employee being among the three highest paid officers for that taxable year (other than the principal executive officer or the principal financial officer). Accordingly, the IRS definition of "covered employee" does not include an executive officer who is the principal financial officer or anyone who acts in that capacity unless such person (x) is also serving as the principal executive officer as of the end of the taxable year, or (y) also holds another executive officer position that is one of the three most highly compensated executive officers of the company for the taxable year.

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The exclusion of the principal financial officer from 162(m) is a surprising result. Therefore, it seems likely that Congress will amend the definition of “covered employee” and the IRS will revise its guidance to include the principal financial officer to achieve the overall goal of conforming definitions of “named executive officers” and “covered employees.” However, as with any legislative change, there is no reliable way to predict when it might be implemented.