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**NEW IRS GUIDANCE ON SECTION 162(M)**

**Only Four Employees Now Subject to Section 162(m); CFO No Longer Included**

To reflect recent changes to SEC executive compensation disclosure rules, the IRS issued Notice 2007-49 on June 4, 2007, to provide interpretative guidance on the definition of “covered employee” under Section 162(m) of the Internal Revenue Code. Under the guidance the chief financial officer (CFO) is excluded and the only covered employees are the chief executive officer (CEO) and the other three “named executive officers” at the end of the year.

**Background.** Section 162(m) imposes an annual \$1 million limitation on the deduction by a publicly-held corporation for compensation of each covered employee, unless compensation is performance-based. A covered employee is defined under Section 162(m) as an employee at the end of the corporation’s taxable year who is either the CEO or an officer whose compensation for the taxable year is required to be reported to shareholders under the SEC proxy disclosure rules because the employee is among the corporation’s four highest compensated officers (other than the CEO) for the taxable year. The Section 162(m) regulations provide that the SEC proxy disclosure rules are used to determine the corporation’s CEO and other four highest compensated officers.

**IRS Notice 2007-49.** The guidance in Notice 2007-49 was issued in response to the amended rules relating to proxy statement disclosure of executive compensation issued by the SEC on August 11, 2006.<sup>1</sup> Among the revisions in the amended rules is a change to the definition of “named executive officers” whose compensation must be disclosed in the proxy statement. Instead of the CEO and the four other most highly compensated officers at the end of the fiscal year as required under the prior proxy disclosure rules (based on salary and bonus), the revised rules treat as named executive officers the CEO<sup>2</sup>, the CFO<sup>3</sup> and the three other most highly compensated officers at the end of the fiscal year (generally based on total compensation).

Notice 2007-49 explains that, as a result of the revisions to the definition of named executive officers under the proxy disclosure rules, the Section 162(m) definition of covered employee “...

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<sup>1</sup> Refer to our letters dated 8/14/06 and 12/28/06, which are available on our website at [http://www.fwcook.com/alert\\_letters/8-14-06\\_Heads-up\\_On\\_Executive\\_Compensation\\_Disclosure.pdf](http://www.fwcook.com/alert_letters/8-14-06_Heads-up_On_Executive_Compensation_Disclosure.pdf) and [http://www.fwcook.com/alert\\_letters/12-28-06\\_Heads-Up\\_On\\_Executive\\_Compensation\\_Disclosure.pdf](http://www.fwcook.com/alert_letters/12-28-06_Heads-Up_On_Executive_Compensation_Disclosure.pdf)

<sup>2</sup> The term used in the proxy disclosure rules is “principal executive officer” and disclosure is required of any employee who served as principal executive officer during the fiscal year.

<sup>3</sup> The term used in the proxy disclosure rules is “principal financial officer” and disclosure is required of any employee who served as principal financial officer during the fiscal year.

does not track the definition of named executive officers in the amended disclosure rules.” The Notice states that the IRS will interpret the covered employee definition for purposes of Section 162(m) to mean the following officers at the end of the corporation’s taxable year:

- The principal executive officer (i.e., the CEO) or anyone acting in that capacity
- The three officers, other than the principal executive officer and principal financial officer (i.e., the CFO) or anyone acting in that capacity, whose compensation for the taxable year is required to be reported to shareholders under the SEC proxy disclosure rules because they are the corporation’s three highest compensated officers for the taxable year

The interpretation specifically provides that the principal financial officer (or anyone acting in that capacity) is not included as a covered employee, and as a result is not subject to the Section 162(m) deduction limitation.

Although not stated in Notice 2007-49, presumably the IRS interpretation applies to taxable years beginning on or after December 15, 2006, to conform to the effective date of the amended proxy disclosure rules.

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This letter is intended to alert compensation professionals about developments that may affect their companies, and should not be considered or relied upon as legal advice. Specific questions about the definition of covered employee under Section 162(m) should be discussed with appropriate counsel. General questions applicable to the covered employee definition may be directed to Richard Alpern in our New York offices at 212-299-3599 or by e-mail at [ralpern@fwcook.com](mailto:ralpern@fwcook.com). Copies of this letter and other published materials are available on our website, [www.fwcook.com](http://www.fwcook.com).