

CORPORATE EXECUTIVE COMPENSATION ALERT

IRS CLARIFIES DEFINITION OF “COVERED EMPLOYEES” UNDER SECTION 162(m)



On June 4, 2007, the Internal Revenue Service issued guidance identifying who is a “covered employee” for purposes of the \$1 million deduction limit on compensation paid to covered employees of a publicly held corporation. Notice 2007-49 reconciles the term “covered employees” under Section 162(m) of the Internal Revenue Code (the Code) with “named executive officers” as defined in the compensation disclosure rules under the Securities and Exchange Act of 1934, as amended (the Exchange Act). Under the Notice, the chief financial officer (CFO) is no longer considered a covered employee, and the only covered employees are the chief executive officer (CEO) and the three other named executive officers at the close of the taxable year.

Code Section 162(m) imposes a \$1 million annual limit on a publicly held corporation’s deduction for compensation paid to each covered employee, with certain exceptions for performance-based compensation. A covered employee under Code Section 162(m) is defined as any employee at the close of the corporation’s taxable year who is the CEO, or any other officer whose compensation for the taxable year is required to be reported to shareholders under the Exchange Act because they are among the four highest compensated officers for the taxable year (other than the CEO). Treasury Regulations under Section 162(m) refer to the executive compensation disclosure rules under the Exchange Act for determining whether an individual is the CEO or among the four other highest compensated officers.

The Securities and Exchange Commission amended the compensation disclosure rules under Item 402 of Regulation S-K on September 8, 2006, altering the composition of the group of “named executive officers” covered by the rules. The new rules increased the number of executives who are named executive officers by virtue of their position from one to two (consisting of the principal executive officer and the principal financial officer), and reduced the number of executives who are named executive officers based on their level of compensation from four to three. As a result, the Code Section 162(m) definition of covered employee no longer mirrors the definition of named executive officer under the Exchange Act rules.

The Notice states that the Internal Revenue Service will interpret the term “covered employee” for purposes of Code Section 162(m) to mean any employee who as of the end of the corporation’s

taxable year is the principal executive officer (within the meaning of the amended disclosure rules) or anyone acting in such capacity, or an officer (other than the principal executive officer or the principal financial officer) whose compensation for the taxable year is required to be reported to shareholders under the Exchange Act by reason of being one of the three highest compensated officers for the taxable year.

The Notice states further that the term “covered employee” does not include the principal financial officer (within the meaning of the amended disclosure rules) or anyone acting in such capacity. As a result of the new guidance, a public company will have only four covered employees for purposes of Code Section 162(m), but will have five named executive officers for purposes of the disclosure rules under the Exchange Act. Any change to conform the definition of “covered employee” under the Code with the named executive officers covered by the disclosure rules under the Exchange Act may require Congressional action to amend the Code. Unless and until such legislation is adopted, the principal financial officer’s compensation is not subject to the \$1 million deduction limitation under Code Section 162(m).

CONTACT INFORMATION

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