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Client Alert

IRS Says CFOs Are Not Covered Employees Under Section 162(m)

Recent Internal Revenue Service Notice 2007-49 addresses the inconsistent definitions of a “named executive officer” in the Securities and Exchange Commission disclosure rules under the Securities Exchange Act of 1934 and “covered employee” in Section 162(m) of the Internal Revenue Code.

The Notice clarifies who is a “covered employee” for purposes of Code section 162(m)’s \$1 million deduction limitation by providing that a company’s principal financial officer will not be considered a covered employee. Pursuant to the Notice, the IRS also lowered the number of individuals other than a company’s principal executive officer who are covered employees from four to three.

Under Code section 162(m), a deduction by a public company for employee remuneration to a covered employee is limited to \$1 million. Under that section, a covered employee is defined as any employee of the taxpayer if, as of the close of the taxable year, such employee was the chief executive officer or an individual acting in such capacity or the employee was among the four highest compensated officers (other than the CEO). Tax regulations state that the determination as to whether an employee is the CEO or among the four highest compensated officers is determined pursuant to the SEC executive compensation disclosure rules under the Exchange Act. Prior to September 2006, the definition of “named executive officer” under the SEC rules was consistent with the definition of “covered employee” under section 162(m), each including an individual serving as CEO and the four most highly compensated executive officers other than the CEO. In September 2006, the SEC amended its executive compensation disclosure rules to provide that named executive officers include a company’s principal executive officer, principal financial officer and the three most highly compensated executive officers (other than the principal executive officer or principal financial officer).

Notice 2007-49 addresses the inconsistent definitions in the Code and SEC disclosure rules by stating that the IRS will interpret the term “covered employee” for purposes of Code section 162(m) to mean any

employee of the taxpayer if, as of the close of the taxable year, such employee is the principal executive officer (within the meaning of the amended disclosure rules) of the taxpayer or an individual acting in such capacity, or if the total compensation of such employee for that taxable year is required to be reported to shareholders under the Exchange Act by reason of such employee being among the three highest compensated officers for the taxable year, other than the principal executive officer or the principal financial officer.

Thus, under the IRS's interpretation, only four named executive officers of a company will be treated as covered employees for purposes of Code section 162(m), and the company's principal financial officer will not be considered a covered employee, unless he or she is also the principal executive officer or one of the three highest paid officers of the company (other than the principal executive officer or principal financial officer).

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