

Part III - Administrative, Procedural, and Miscellaneous

Covered Employees under section 162(m)(3)

Notice 2007-49

PURPOSE

This notice provides guidance on identifying covered employees for purposes of §162(m)(3) of the Internal Revenue Code.

BACKGROUND

Section 162(a)(1) allows as a deduction all of the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered.

Section 162(m)(1) provides, in general, that in the case of any publicly held corporation, no deduction shall be allowed for applicable employee remuneration with respect to any covered employee to the extent that the amount of such remuneration for the taxable year with respect to such employee exceeds \$1,000,000.

Section 162(m)(3) defines a "covered employee" as any employee of the taxpayer if, (A) as of the close of the taxable year, such employee is the chief executive officer of the taxpayer or is an individual acting in such a capacity, or (B) the total compensation of such employee for the taxable year is required to be reported to shareholders under the Securities Exchange Act of 1934 by reason of such employee being among the 4 highest compensated officers for the taxable year (other than the chief executive officer).

Section 1.162-27(c)(2)(ii) of the Income Tax Regulations provides that whether an individual is the chief executive officer or among the four highest compensated officers (other than the chief executive officer) is determined pursuant to the executive compensation disclosure rules under the Exchange Act.

The Securities and Exchange Commission's ("SEC") rules relating to executive compensation disclosure under the Exchange Act are contained in Item 402 of Regulation S-K, 17 CFR 229.402. A final rule amending the SEC executive compensation disclosure rules was published in the Federal Register on September 8, 2006 (71 FR 53158) ("amended disclosure rules"). Among other things, the amended disclosure rules altered the composition of the group of executives that are covered by the disclosure rules. Like the pre-amendment disclosure rules ("old disclosure rules"), the amended disclosure rules refer to these executives as "named executive officers." Companies must comply with the amended disclosure rules for fiscal years ending on or after December 15, 2006.

Under the amended disclosure rules, named executive officers consist of, in relevant part, (i) all individuals serving as the registrant's principal executive officer or acting in a similar capacity during the last completed fiscal year ("PEO"), regardless of compensation level; (ii) all individuals serving as the registrant's principal financial officer or acting in a similar capacity during the last completed fiscal year ("PFO"), regardless of compensation level; and (iii) the registrant's three most highly compensated executive officers other than the PEO and PFO who were serving as executive officers at the end of the last completed fiscal year. Under the old disclosure rules, named executive officers consisted of, in relevant part, (i) all individuals serving as the registrant's chief executive officer or acting in a similar capacity during the last completed fiscal year ("CEO"), regardless of compensation level; and (ii) the registrant's four most highly compensated executive officers other than the CEO who were serving as executive officers at the end of the last completed fiscal year.

The definition of covered employee in §162(m)(3) mirrored the definition of named executive officers under the old disclosure rules, but it is not the same as that definition under the amended disclosure rules. This is because the amended disclosure rules increase the number of executives who are named executive officers by virtue of their position from one to two, and reduce the number of executives who are named executive officers based on their compensation level from four to three. Thus, while the amended disclosure rules continue to require disclosure for five executive officers, two executives are now covered by the rules based on their positions, and three are covered by the rules based on their level of compensation. In contrast, a covered employee for purposes of § 162(m)(3) consists of only one executive officer based on his or her position and four officers based on their level of compensation.

Under §162(m)(3) and §1.162-27(c)(2)(ii), covered employees are determined by looking to the Exchange Act. Thus, guidance clarifying the meaning of covered employees is necessary because the definition in § 162(m)(3) does not track the definition of named executive officers in the amended disclosure rules. In particular, guidance is necessary because the amended disclosure rules (1) require disclosure for the principal executive officer, while the definition of covered employee in § 162(m)(3)(A) uses the term chief executive officer; (2) require disclosure based on compensation level for three executive officers, while the definition of covered employee in §162(m)(3)(B) applies the deduction limitation by reason of compensation level to four officers; and (3) require disclosure with respect to the principal financial officer by reason of that officer's position (and not by reason of such officer being among the taxpayer's highest compensated officers), while the only officer within the scope of §162(m) based on a specific position is the chief executive officer.

Accordingly, based upon the statutory language of §162(m)(3), which has not been amended since the amended disclosure rules were promulgated, the following guidance is provided. The IRS will interpret the term "covered employee" for purposes of § 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 a 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 3 highest compensated officers for the taxable year (other than the principal executive officer or the principal financial officer). Accordingly, the term covered employee for purposes of §162(m) does not include those individuals for whom disclosure is required under the Exchange Act on account of the individual being the taxpayer's principal financial officer (within the meaning of the amended disclosure rules) or an individual acting in such a capacity.

The principal author of this notice is Jean Casey of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt & Government Entities). For further information regarding this notice contact Jean Casey at (202) 622-6030 (not a toll-free call).