IRS Issues Guidance on the Applicability of Section 162(m) to CFO Compensation

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Summary: The IRS recently informally revised its guidance regarding which officers of public companies must be considered when determining the compensation deduction limitation of Section 162(m) of the Internal Revenue Code and applied the limitation to CFOs of certain smaller public companies. Since the release of IRS Notice 2007-49, practitioners have understood that the deduction limitation applies only to compensation paid to a public company's CEO and its three most highly compensated individuals (other than the CEO or CFO) and that, by a quirk of cross-referencing between the Code and the Securities and Exchange Commission's (SEC) compensation disclosure rules, Section 162(m) does not apply to compensation paid to the company's CFO, irrespective of the SEC reporting regime applicable to the public company. However, in a Chief Counsel Advice (CCA) legal memorandum issued on August 24, 2015 (and made publicly available in late October), the IRS concluded that the compensation paid to the principal financial officer of a "smaller reporting company" can, in certain circumstances, be subject to the deduction limitation of Section 162(m).

Background: Section 162(m) of the Code generally disallows the deduction of compensation paid by a public company to a "covered employee" in any one taxable year to the extent it exceeds $1 million. The definition of "covered employee" was drafted to track the definition of a "named executive officer" in Item 402 of SEC Regulation S-K as in effect when Section 162(m) was enacted in 1993. Therefore a "covered employee" was defined as (1) the person who is the CEO (or an individual acting in the capacity of the CEO) as of the close of the taxable year and (2) the four other most highly compensated executives whose total compensation for the taxable year is required to be reported to shareholders under the Securities Exchange Act of 1934. Regulations under Section 162(m) make clear that whether someone is a "covered employee" is determined pursuant to the rules under the Exchange Act.

However, in 2006, the SEC amended Item 402 and, in doing so, changed the definition of "named executive officer." Rather than requiring disclosure of the CEO's compensation by virtue of his or her position and of the compensation of four other individuals by virtue of their compensation, the amended rules require disclosure of the compensation of both the principal executive officer and the principal financial officer by virtue of their positions and of the three most highly compensated

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executives (other than the principal executive officer and the principal financial officer) by virtue of their compensation. In response to the amendments the IRS issued Notice 2007-49 in which it concluded that the definition of “covered employee” would no longer include a public company’s principal financial officer (leaving the covered employees to be the CEO and the three other most highly compensated employees (other than the CFO)). Only an act of Congress to amend Code Section 162(m) can restore alignment between the definition of "covered employee" and the definition of "named executive officer" in Item 402.

New Guidance and Open Questions: The CCA revisits the definition of “covered employee” in light of the scaled-back disclosure rules for “smaller reporting companies” adopted by the SEC in 2008. Under the rules applicable to smaller reporting companies, a “named executive officer” includes the principal executive officer by virtue of his or her position, and the company’s two other most highly compensated executive officers by virtue of their compensation. The rules do not require disclosure of compensation of an officer by reason of his or her position as the principal financial officer and are, effectively, a narrower version of the pre-2006 definition of “named executive officer” described above. Therefore, in the CCA, the IRS concluded that where a principal financial officer is one of the two most highly compensated executive officers of a smaller reporting company, he or she will be a covered employee under Section 162(m).

The CCA leaves open several questions, including (1) whether a smaller reporting company need only be eligible to rely on the scaled-back disclosure rules or whether it must actually rely on them, in order for Section 162(m) to apply to compensation paid to the company’s principal financial officer; (2) whether compensation paid to the principal financial officers of emerging growth companies, which are also eligible to rely on the same scaled-back disclosure rules, will also be subject to Section 162(m); and (3) how the IRS will treat deductions already claimed for compensation paid in excess of the $1 million limitation to CFOs of smaller reporting companies or emerging growth companies since 2008.

Going Forward: A CCA is not precedential authority. Nevertheless a smaller reporting company, or emerging growth company for that matter, should now consider carefully whether or not compensation paid to its CFO after the end of its applicable Section 162(m) transition period (including as a result of RSUs that were granted during the transition period but that vest following the expiration of the transition period, as described in our previous client alert) will be subject to Section 162(m). (Timing is paramount here. Because the status of "covered employee" is determined in the year in which compensation is deductible, not when, for example, multi-year awards are granted, a CFO could be a covered employee at the date of grant because the company is a smaller reporting company, and yet not be a covered employee when the compensation attributable to the award is deducted in a later year.) Care should also be taken in drafting Section 162(m) disclosure, if any, included in the company’s annual proxy statement.

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