

IRS Releases Advice Addressing Section 162(m) and CFO Compensation of Smaller Reporting Companies

By Jessica Lutrin, Susan P. Serota and Peter J. Hunt

Section 162(m) of the Internal Revenue Code (Code) limits, subject to certain exceptions, a public company's federal income tax deduction for compensation paid to any "covered employee" to \$1 million in any taxable year. A public company's principal financial officer (PFO) is excluded from the scope of "covered employees." However, in October 2015, the Office of the Chief Counsel of the Internal Revenue Service (IRS) released a Chief Counsel Advice (CCA) memorandum addressing the application of Section 162(m) to PFO compensation of smaller reporting companies. CCA memoranda are not binding, but they do illuminate how the IRS interprets the Code.

Covered Employees

The definition of a "covered employee" under Section 162(m)(3) of the Code is tied to the definition of a "named executive officer" in the federal securities law disclosure rules in effect prior to 2006 under Item 402 of Regulation S-K. Section 162(m)(3) of the Code defines "covered employees" as the public company's Chief Executive Officer (or the individual serving in that capacity) and the four most highly compensated executive officers whose compensation is subject to the disclosure rules, in each case at the end of the taxable year.

In 2006, the definition of "named executive officer" under Item 402 was amended. As amended, the following individuals are "named executive officers" for purposes of the disclosure rules:

	Principal Executive Officer	Principal Financial Officer	Executive Officers
Accelerated Filers (including Large Accelerated Filers) <i>Item 402(a)(3) of Regulation S-K</i>	All individuals serving as the company's principal executive officer (PEO) or serving in a similar capacity during the last completed fiscal year, regardless of compensation level	All individuals serving as the company's PFO or serving in a similar capacity during the last completed fiscal year, regardless of compensation level	The three most highly compensated executive officers (other than the PEO and the PFO) who were serving as executive officers at the end of the last completed fiscal year
Smaller Reporting Companies¹ <i>Item 402(m)(2) of Regulation S-K</i>	Same as Accelerated Filers	N/A	The two most highly compensated executive officers (other than the PEO) who were serving as executive officers at the end of the last completed fiscal year

However, corresponding amendments were not enacted to Section 162(m)(3) of the Code. As such, there was a disconnect between the definition of "covered employee" under Section 162(m)(3) and "named executive officer" under Item 402. In an effort to reconcile this disconnect, the IRS issued [IRS Notice 2007-49](#) in which the IRS interpreted the term "covered employee" to specifically exclude a public company's PFO or an individual serving in such capacity.

Practitioners relied on this guidance to exclude a company's PFO from the applicability of the deduction limitation under Section 162(m) of the Code, regardless of such officer's level of compensation and regardless of whether the issuer was a smaller reporting company. Thus, following the release of IRS Notice 2007-49, the following executive officers have been treated as "covered employees" under Section 162(m)(3) of the Code:

- all individuals serving as the company's PEO or serving in a similar capacity during the last completed fiscal year; and
- a company's three (or, in the case of smaller reporting companies, two) most highly compensated executive officers (other than the company's PEO and PFO).

Smaller Reporting Companies

Rule 12b-2 of the Securities Exchange Act of 1934 generally defines a smaller reporting company as an issuer that is not an investment company, an asset-backed issuer or a majority-owned subsidiary of a parent that is not a smaller reporting company, and that has a public float of less than \$75 million or does not have a public float, but has annual revenues of less than \$50 million.

A company that qualifies as a smaller reporting company may take advantage of the less onerous disclosure and reporting requirements in Item 402(m) of Regulation S-K (including, disclosing the compensation of a smaller group of "named executive officers" under Item 402(m)(2)).



¹ As discussed below, emerging growth companies are also eligible to rely on these rules.

CCA Memorandum

On October 23, 2015, the Office of the Chief Counsel released CCA Memorandum 201543003 (dated August 24, 2015) in which a distinction was drawn between the “covered employees” of accelerated filers (including large accelerated filers) and smaller reporting companies. While CCA memoranda are not binding, they are valuable in understanding how the IRS interprets and applies the Code.

The CCA memorandum describes the following factual scenario: An employee (Employee A) served as the PFO of a smaller reporting company (Corporation X) for 2014 through the end of 2014. Employee A was also the second highest compensated executive officer of Corporation X for 2014, other than Corporation X’s PEO.

The Office of the Chief Counsel asserts that, as the PEO is the only officer of a smaller reporting company who is a “covered employee” under Section 162(m)(3) of the Code by virtue of serving in a specific position, IRS Notice 2007-49 does not preclude treating the PFO as a “covered employee” by virtue of such officer’s level of compensation. The Office of the Chief Counsel concludes that the disclosure rules for smaller reporting companies require the disclosure of the compensation of the PFO if such individual is one of the two most highly compensated individuals (other than the PEO) who were serving as executive officers at the end of the taxable year.

Therefore, in the factual scenario described above, Employee A is a covered employee of Corporation X for 2014 by reason of being one of Corporation X’s two most highly compensated executive officers.

Practical Considerations

Like smaller reporting companies, emerging growth companies (EGCs) are also entitled to rely on the limited disclosure rules in Item 402(m) of Regulation S-K. The Office of the Chief Counsel, however, does not address the applicability of its conclusion to EGCs. In addition, and most notably, the Office of the Chief Counsel does not address how the conclusion in the CCA memorandum impacts the deductibility of compensation paid to a smaller reporting company’s (or an EGC’s) PFO before the release of this memorandum. Although the CCA memorandum is not binding, smaller reporting companies and EGCs should consider whether any changes to their approach to the deduction limitation under Section 162(m) of the Code and related disclosure would be appropriate.

If you have any questions about the content of this alert please contact the Pillsbury attorney with whom you regularly work, or the authors below.

Jessica Lutrin [\(bio\)](#)
New York
+1.212.858.1090
jessica.lutrin@pillsburylaw.com

Susan P. Serota [\(bio\)](#)
New York
+1.212.858.1125
susan.serota@pillsburylaw.com

Peter J. Hunt [\(bio\)](#)
New York
+1.212.858.1139
peter.hunt@pillsburylaw.com

About Pillsbury Winthrop Shaw Pittman LLP

Pillsbury is a full-service law firm with an industry focus on energy & natural resources, financial services including financial institutions, real estate & construction, and technology. Based in the world's major financial, technology and energy centers, Pillsbury counsels clients on global business, regulatory and litigation matters. We work in multidisciplinary teams that allow us to understand our clients' objectives, anticipate trends, and bring a 360-degree perspective to complex business and legal issues—helping clients to take greater advantage of new opportunities, meet and exceed their objectives, and better mitigate risk. This collaborative work style helps produce the results our clients seek.

This publication is issued periodically to keep Pillsbury Winthrop Shaw Pittman LLP clients and other interested parties informed of current legal developments that may affect or otherwise be of interest to them. The comments contained herein do not constitute legal opinion and should not be regarded as a substitute for legal advice.

© 2015 Pillsbury Winthrop Shaw Pittman LLP. All Rights Reserved.