IRS Issues New Guidance for Smaller Reporting Companies on CFO Compensation

December 16, 2015

In a recently released Chief Counsel Advice memorandum ("CCA"),[1] the Internal Revenue Service ("IRS") informally revised its guidance regarding which officers of "smaller reporting companies" ("SRCs")[2] should be considered "covered employees" when applying the compensation deduction limitation under Section 162(m) of the Internal Revenue Code of 1986, as amended ("Code"). The IRS stated that the compensation paid to the principal financial officer ("PFO," commonly referred to as a "CFO") of an SRC may be subject to the deduction limitation under Section 162(m) in certain circumstances. The new IRS guidance is contrary to the prior understanding among practitioners that the deduction limitation only applied to a publicly held corporation's principal executive officer ("PEO," commonly referred to as a "CEO") and its three (two, in the case of SRCs) most highly compensated executive officers *other than* the PEO or the PFO.

The Regulatory History

Original Interpretation of "Covered Employees"

In general, Section 162(m) of the Code prohibits publicly held corporations from deducting more than $1 million per year in compensation paid to each "covered employee." Section 162(m)'s definition of a "covered employee" was originally drafted to mirror the Securities and Exchange Commission ("SEC") executive compensation disclosure rules. Section 162(m) includes any employee of the corporation who serves as the PEO or any employee whose total compensation is required to be reported to shareholders under the Securities Exchange Act of 1934, as amended ("Exchange Act"), because the employee is one of the four highest compensated officers for the taxable year (other than the PEO). Further guidance is found in Section 1.162-27(c)(2)[3] of the Treasury Regulations, which provides that the executive compensation disclosure rules contained in Item 402 of Regulation S-K[4] should be used to determine if someone was the PEO or one of the four highest compensated officers. Originally, the IRS's definition and the SEC's disclosure rules worked together for determining Section 162(m)'s applicability.

[1] Read the full CCA here. The CCA was issued August 24, 2015 but not released until October 23, 2015.
[2] The SEC maintains different levels of disclosure and reporting requirements depending on the size of the issuer as measured under specific financial tests. In general, an SRC has either (i) less than $75 million in public common equity float or (ii) for companies with no public common equity float, have less than $50 million in revenue during its previous fiscal year.
[3] 26 C.F.R. § 1.162-27.
[4] 17 C.F.R. § 229.402.

NEO Group Modified by the SEC in 2006

However, in 2006, the SEC amended the executive compensation disclosure rules that, among other things, changed the composition of the group of executives who were deemed to be "named executive officers." Under the amended rules, a publicly held corporation generally is required to disclose compensation for the PEO (regardless of compensation level), PFO (regardless of compensation level), and the corporation'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 fiscal year.

IRS Response to the SEC Amendment

This change created confusion regarding whether the PFO should be treated as a "covered employee" for purposes of Section 162(m). The IRS attempted to clarify the ambiguity with IRS Notice 2007-49 ("Notice"). The Notice provides that the term "covered employee" for purposes of Section 162(m) *does not* include those individuals for whom disclosure is required under the Exchange Act by reason of the individual being the taxpayer's PFO (within the meaning of the SEC's amended disclosure rules). The Notice concluded that the term "covered employee," for purposes of Section 162(m), means any employee of the taxpayer if, at the end of the taxable year, (i) such employee is the PEO (within the meaning of the SEC's disclosure rules) of the taxpayer, or (ii) 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 PEO or the PFO). In order to truly align the definitions of "covered employee" under Section 162(m) of the Code and "named executive officer" under Item 402 of Regulation S-K, Congress would have to amend Section 162(m).

Prior Consensus for Treatment of SRCs

The scaled-back SEC disclosure rules for SRCs reduce the number of named executive officers whose compensation must be disclosed to the PEO and the two most highly compensated executive officers (other than the PEO). In contrast to most other publicly held corporations, the disclosure rules for SRCs do not require disclosure of compensation of an officer by reason of the individual serving as PFO. Practitioners generally understood that the Notice applied to SRCs as it did to other publicly held corporations, and thus meant that a PFO of an SRC was *not* a "covered employee" under Section 162(m).

The New IRS Guidance

However, the IRS informally revised its prior guidance by concluding in the CCA that a PFO could meet the definition of a "covered employee" in the context of an SRC. Specifically, the IRS determined that the PFO of an SRC is a "covered employee" for purposes of Section 162(m), *if* the PFO is one of the two most highly compensated executive officers, other than the PEO, who were serving as executive officers at the end of the taxable year.

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Unfortunately, the CCA's informal revision also created several areas of uncertainty. For instance, it is unclear, in the context of an SRC determining not to take advantage of the scaled-back disclosure requirements, if that decision will affect the applicability of Section 162(m) to the PFO's compensation. In addition, it is unclear whether "emerging growth companies"[5] will be treated similarly to SRCs in regards to Section 162(m). Moreover, SRCs may have previously deducted compensation paid to PFOs that may no longer be deductible; it is uncertain how the IRS will treat those previous deductions.

Despite the uncertainty created by the IRS's conclusion in the CCA, SRCs should evaluate whether its PFO is one of the two most highly compensated executive officers. If so, the SRC will be subject to Section 162(m)'s limitation on deducting its PFO's compensation and should evaluate its compensation arrangements and related proxy statement disclosures to determine if changes should be made.

Contact Information

If you have any questions concerning the recent IRS guidance, please contact Morgan Arndt, the principal drafter of this client alert, at MArndt@wcsr.com or 864.255.5416, or you may contact the Womble Carlyle attorney with whom you usually work or one of our Corporate and Securities attorneys.

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[5] Emerging growth companies are a new category of issuer, which has reduced disclosure requirements; created by the Jumpstart Our Business Startups Act of 2012 ("JOBS Act"). For more information regarding the JOBS Act, please see our client alert here.