

**Office of Chief Counsel  
Internal Revenue Service  
memorandum**

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from: Thomas Scholz, Senior Counsel  
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subject: Principal Financial Officer of Smaller Reporting Company as Covered Employee under §162(m)(3)

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

Whether Employee A, the principal financial officer (PFO) of a smaller reporting company, is a “covered employee” within the meaning of §162(m)(3) of the Internal Revenue Code (Code).

CONCLUSION

Employee A is a “covered employee” within the meaning of §162(m)(3).

FACTUAL SCENARIO

Corporation X is a publicly held corporation. For 2014, Corporation X is eligible to comply with the executive compensation disclosure requirements under the Securities Exchange Act of 1934 (Exchange Act) by satisfying the disclosure rules required of a smaller reporting company under Item 402(m) of Regulation S-K. Employee A served as the PFO of Corporation X at the end of 2014. Employee A is the second highest compensated executive officer of Corporation X for 2014 other than the principal executive officer (PEO).

LAW

Section 162(a)(1) of the Code allows a deduction for all 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) of the Code provides that for 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 exceeds \$1 million.

Section 162(m)(2) of the Code defines the term “publicly held corporation” to mean any corporation issuing any class of common equity securities required to be registered under section 12 of the Exchange Act.

Section 162(m)(3) of the Code defines the term “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 capacity, or (B) the total compensation of such employee for the taxable year is required to be reported to shareholders under the Exchange Act by reason of such employee being among the four highest compensated officers for the taxable year (other than the chief executive officer).

Section 1.162-27(c)(2) of the Income Tax Regulations provides that a covered employee is any individual who, on the last day of the taxable year, is (A) the chief executive officer of the corporation or is acting in such capacity; or (B) among the four highest compensated officers (other than the chief executive officer). Whether an individual is the chief executive officer or one of the four highest compensated officers is determined pursuant to the executive compensation disclosure rules under the Exchange Act (disclosure rules). See section 1.162-27(c)(2)(ii). The disclosure rules are contained in Item 402 of Regulation S-K, 17 CFR 229.402. These rules require disclosure of compensation awarded to, earned by, or paid to certain executive officers.

For fiscal years ending before December 15, 2006, the disclosure rules provided that 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, regardless of compensation level; and (ii) the registrant's four most highly compensated executive officers other than the chief executive officer who were serving as executive officers at the end of the last completed fiscal year. On September 8, 2006, the Securities and Exchange Commission issued a final rule amending the disclosure rules (71 FR 53158). Among other things, the amended disclosure rules altered the composition of the group of executives who are covered by the disclosure rules. Like the pre-amendment disclosure rules, the amended disclosure

rules refer to these executives as “named executive officers.” Under the amended disclosure rules, named executive officers consist of, in relevant part:

- i. all individuals serving as the registrant's PEO or acting in a similar capacity during the last completed fiscal year, regardless of compensation level;
- ii. all individuals serving as the registrant's PFO or acting in a similar capacity during the last completed fiscal year, regardless of compensation level;
- iii. the registrant's 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; and
- iv. up to two additional individuals for whom disclosure would have been provided but for the fact that the individual was not serving as an executive officer of the registrant at the end of the last completed fiscal year.

Companies were required to comply with the amended disclosure rules for fiscal years ending on or after December 15, 2006.

In response to the amended disclosure rules, the IRS issued Notice 2007-49, 2007-1 C.B. 1429. Notice 2007-49 provides that the IRS will interpret the term "covered employee" for purposes of section 162(m) to mean any employee of the taxpayer if, as of the close of the taxable year, such employee is the PEO (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 three highest compensated officers for the taxable year (other than the PEO or the PFO). The Notice also 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 amended disclosure rules) or an individual acting in such a capacity.

With respect to smaller reporting companies, Item 402(m) of Regulation S-K provides that the named executive officers consist of, in relevant part: (i) all individuals serving as the PEO or acting in a similar capacity during the last completed fiscal year, regardless of compensation level; (ii) 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; and (iii) up to two additional individuals for whom disclosure would have been provided but for the fact that the individual was not serving as an executive officer of the smaller reporting company at the end of the last completed fiscal year.

## ANALYSIS

Under §162(m)(3), an employee is a covered employee if such employee is the chief executive officer or if the total compensation of such employee is required to be reported to shareholders under the Exchange Act by reason of such employee being among the four highest compensated officers for the taxable year (other than the chief executive officer). Interpreting §162(m)(3)(B) in light of the amended disclosure rules,

Notice 2007-49 provides that a covered employee includes the PEO and an officer whose total compensation is required to be disclosed by reason of such employee being among the three highest compensated officers for the taxable year (other than the PEO and the PFO). Thus, the PEO is the only officer who is a covered employee by reason of serving in a specific position. Under the notice, the PFO is not a covered employee when the disclosure relating to the PFO is required by reason of the individual serving as PFO. Notice 2007-49 does not preclude the PFO from qualifying as a covered employee if disclosure relating to the PFO is required by reason of such officer being among the highest compensated officers.

For smaller reporting companies, the disclosure rules require disclosure of compensation for the PEO (based on his or her service as the PEO) and the two most highly compensated executive officers other than the PEO who were serving as executive officers at the end of the year. The disclosure rules for smaller reporting companies do not require disclosure of compensation of an officer by reason of the individual serving as PFO. Instead, the disclosure rules require disclosure of compensation for the PFO of a smaller reporting company *only* 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 year. In accordance with §162(m)(3)(B) and Notice 2007-49, the PFO of a smaller reporting company is a covered employee 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 year.

Employee A is a “covered employee” within the meaning of §162(m)(3) because the compensation of Employee A is disclosed by reason of Employee A being one of the two highest compensated executive officers (other than the PEO).

Please call Ilya Enkichev at (202) 317-5600 if you have any further questions.