THE CORPORATE EXECUTIVE

PUBLISHER: JESSE M. BRILL P.O. Box 3895, San Francisco, CA 94119

THE NEWSLETTER FOR THOSE THAT ADVISE PUBLIC COMPANIES

Vol. XX, No. 4 *September-October 2006*

Impact of NEO Changes on Section 162(m)

The NEO Changes—Effect on Code Section 162(m) Covered Executives?

The executive compensation disclosure changes, which do apply to 2006 (*i.e.,* any fiscal year ending on or after December 15, 2006—see 1934 Act Rel. No. 34-54302, August 11, 2006), tweak the named executives who are required to be included in the disclosure tables in the proxy statement/10-K, but this seemingly minor change shuffles the cards in the context of who is subject to Section 162(m)'s $1,000,000 limit on the tax deductibility of non-performance based compensation.

As our readers know, companies previously were required to include in the tables (a) any person who was the CEO at any time during the fiscal year, (b) the four highest-paid, non-CEO executive officers employed at the end of the year, and (c) up to two additional non-CEO executive officers who had departed by yearend whose compensation would have placed them in the top four. (See the November-December 1993 issue of *The Corporate Counsel* at page 6.) Now, per new subsections (a)(3)(ii) and (iii) of Reg S-K Item 402, the subject non-CEO executives are the "principal financial officer" and the three other highest-paid executive officers. (The two additional departeds provision, *i.e.,* (c) above, still applies.)

Section 162(m)(3) defines as "covered employees" the CEO and those other employees whose compensation the SEC requires to be reported "*by reason of* [emphasis added] … being among the four highest compensated officers …." Since the SEC's new PFO disclosure requirement is not by reason of being among the (four) highest paids, it is now at least questionable whether the PFO is a covered employee under Section 162(m). And, is the fourth highest-paid non-PEO (the SEC now uses "principal executive officer" instead of CEO), non-PFO no longer subject to Section 162(m)? [The PFO's compensation may or may not fall within the top four. Even if within the top four, however, the PFO compensation disclosure requirement is no longer based on being in the top four, as specified in §162(m)'s definition of covered employees. As for the fourth highest other executive officer (posit four non-PEOs with higher pay than the PFO), we would think the result must be that the fourth highest is no longer subject to Section 162(m), in that s/he is not required to be reported in the tables. (Section 162(m) requires both (i) four highest and (ii) required reporting.) Presumably, the SEC's *reducing* the number of Section 162(m) persons has always been possible, based on the wording of Section 162(m). But, theoretically, could the SEC increase §162(m) coverage, *e.g.,* what if the new rules called for the five highest-paid non-CEOs?]

A Little History

Section 162(m), adopted in 1993, essentially tracked the SEC's coverage that had been adopted with the SEC's executive compensation disclosure overhaul in 1992, *i.e.,* the CEO and four other highest paids, with anyone not employed on the last day of the fiscal year not includable in the tables. Even after the 1993 SEC amendment that added departed CEOs and up to two other departed executives (who would have been in the top four), the IRS stuck with the original SEC framework (arguably, because Section 162(m) doesn't permit more than one CEO and four NEOs in any event—see below), *i.e.,* only the *year-end* CEO and the four other highest paids. (See our November/December 2001 issue at pg 6.) [Subjecting terminated executives to Section 162(m) might render non-deductible substantial severance paid in the fiscal year of termination. See our November-December 1993 issue at pg 3.]

Now, the question arises whether the IRS will take a similar approach, *i.e.,* sticking again to the 1992 original SEC framework. We have heard that the IRS has said that it intends to issue "guidance" that will conform Section 162(m) to the SEC's new approach, *i.e.,* the PEO, the PFO, and three other highest paids (maybe also finding a way to include the departeds that the SEC includes?). But, some tax practitioners have questioned the IRS' authority to subject the PFO to §162(m) consistent with subsection (3)(B), which (as mentioned above) doesn't literally extend to a non-CEO who is required to be included in the tables for a reason other than being in the top four, *i.e.,* because the person is the PFO. Because 2006 is affected, we would expect to hear from the IRS soon.

Legislation by Regulation?

Can the IRS by regulation or ruling (or other mere guidance) (1) subject the PFO to §162(m), and (2) confirm that the fourth highest is no longer subject to §162(m)? Some think the IRS cannot subject the PFO to §162(m) (even where within the top four), unless and until Congress steps in to modify Section 162(m) itself.

IRS guidance is needed no matter which way the Service decides to go: either (i) the literal (3)(B) approach, *i.e.,* just the CEO and the other top three, or (ii) the CEO, the PFO and the top three. [Continu-

ing to stick with the 1992 framework (*i.e.,* the year-end CEO plus top four) may not be feasible from a practical standpoint, even if doable under the Code, in that someone not named in the disclosure tables could end up being subject to §162(m) (*i.e.,* where four non-PEO executives are paid more than the PFO). If the IRS were to apply §162(m) to someone not even named in the tables, that would be fodder for tax audit issues, wasted time, etc., but unfortunately that kind of consideration doesn't always deter the IRS.]

IRS Accountability. While the IRS does possess broad authority to give effect to the tax laws, its authority does not extend beyond the express terms of the laws (or allow contradiction). Thus, the IRS may not be able to justify subjecting the PFO to Section 162(m), absent legislation. [Our readers will recall that the IRS was judged to have exceeded its authority in ruling that income recognized from the disqualifying disposition of ISO stock was not "wages" and, therefore, not subject to tax withholding (see the Tax Court opinion in *Sun Microsystems* (Feb. 13, 1995, CCH Dec. ¶50,478(M)) and our November-December 2001 issue at pg 1). Ultimately, as discussed in our May-June 2005 issue (at pg 7), Congress amended Code Sections 3121(a), 209(a), 3306(b), and subsection (e) of §3231, to exclude this income from FICA/FUTA wages, and amended Code Sections 421(b) and 423(c) to exempt it from withholding, as part of the Jobs Act (see our November-December 2004 issue at pg 5), which (perhaps in exchange for this favor) gave us Code Section 409A to live with.]

SEC Relief, Instead?

The SEC may have created this problem inadvertently. [Unnecessarily it would seem, based on a December 12, 2005 WSJ article reporting that CFOs/PFOs are receiving significantly more pay than previously (and usually fall in the top four anyway), *e.g.,* due to increased CFO responsibilities such as the SOX financial statement certifications.]

An alternative to Congressional action would be for the SEC to revisit the NEO changes (why not just go back to the top four?), which it might be able to do at the same time as its deferred action on the proposed "Katie Couric" compensation disclosure provision (which we still think won't see the light of day). [We note that, in its comment letter on the proposed new SEC rules, the ABA had asked that the new NEO definition not become effective until 2007, in order to allow time for tax planning. That would have avoided the situation here, where companies will not find out until late 2006 whether a particular executive's pay is subject to §162(m).]

Total Compensation vs. Salary and Bonus

The new rules determine the non-PEO, non-PFO top three based on "total" compensation (as defined in Instruction 1 to S-K Item 402(a)(3)), rather than just salary and bonus as under the old rules. There shouldn't be a §162(m) coverage problem here, in that (3)(B) is non-specific in this regard, so accommodates using the SEC's method of determining high-paids. Howard Golden of Mercer Worldwide points out, however, that there may now be less certainty as to who will end up being the top three, until everything is tallied up after the end of the year when it is too late to do anything to plan around non-performance compensation in excess of $1,000,000. It may take a few years' experience to get a handle on whether this one will actually be a problem (*e.g.,* are significant amounts actually unknown until after yearend?).

Transition for NEO Changes

As our readers know, the Summary Compensation Table includes compensation of subject persons going back two additional years. However, because of the many changes in the way compensation must now be disclosed (see Alan Kailer's revised *Preparing the Executive Compensation Tables*, already available on TheCorporateCounsel.net), the new rules provide that in the 2007 proxy statement which reports 2006 compensation, the SCT will not be required to go back to 2005 or 2004 (even for persons who were NEOs in those years). And, in the 2008 proxy statement reporting 2007, the SCT would include only 2007 and 2006. It will be interesting to see whether the Pfizers of the world may include all three years from the get-go. Inclusion of prior years in the SCT doesn't, by itself, subject those persons' compensation to §162(m) for those prior years.

A Thank You

We thank Tahir Naim of Fenwick & West in Mountain View, California, for helping us sort through the foregoing. We look forward to the October 11 "The IRS and Treasury Speak" session at the NASPP Conference, for word from the IRS on where they are going here (and from practitioners on where the IRS ought to be going).