

Executive Compensation and Benefits Memo

Changes to \$1 Million Limit Coverage

February 9, 2007

The new SEC executive compensation disclosure rules have introduced uncertainty as to which corporate officers' compensation is subject to the \$1 million limit on tax deductible compensation. Legislation pending in Congress would address this uncertainty, and would also expand the group of officers covered by the limit. This memorandum briefly discusses these changes.

Effect of Executive Compensation Disclosure Rules

Under the \$1 million limit, annual compensation received by each "covered employee" of a public company is not tax deductible by the company to the extent that it exceeds \$1 million. The term "covered employee" is defined in the tax code to mean the company's chief executive officer and each of the other employees whose annual compensation must be reported in the company's proxy statement because the employee is among the four highest compensated officers for the year (other than the chief executive officer).

Before 2007, SEC rules required proxy statement disclosure of compensation paid to a company's chief executive officer and to the four other executive officers receiving salary and bonus in excess of \$100,000 whose compensation was greatest. Under the new SEC rules, compensation must be disclosed in the proxy statement for the company's principal executive officer (PEO), principal financial officer (PFO), and the three other most highly compensated executive officers.

The new compensation disclosure rules raise questions as to whose compensation is subject to the \$1 million limit in cases where the PFO is not among the highest paid officers. We

understand that some practitioners also have concluded that, because the inclusion of the PFO results from the officer's position, rather than resulting from compensation level, the PFO should not be subject to the \$1 million limit. The IRS has said that it is reviewing the effect of the new compensation disclosure rules on the determination of covered employees and intends to issue guidance soon.

In an effort to better understand the IRS position in the interim, we recently spoke with senior IRS representatives about the determination of persons who are covered employees. According to those conversations, the IRS had not yet reached a final decision as to the method of determining the identity of covered employees under the new rules. However, we received no indication that the guidance would categorically exclude the PFO from the \$1 million limit. Accordingly, we advise caution in assuming that the limit will apply only to four rather than five officers, or that the PFO will not be subject to the new rules by reason of the SEC rule changes.

Pending Legislation

Legislation pending in Congress would, if enacted, make changes to the determination of who is a covered employee. The legislation would define "covered employee" as the chief executive officer and the four other most highly compensated officers, and would eliminate the requirement that a covered employee be someone whose compensation is required to be reported in the proxy statement. This change would eliminate the uncertainty caused by the changes to the compensation disclosure rules, and generally would maintain the operation of the \$1 million limit as in effect prior to 2007.

The legislation would also provide that if an employee was determined to be a covered employee for any year under the method described in the preceding paragraph, he or she would continue to be treated as a covered employee for all subsequent years. Under the rules as currently in effect, an employee will be treated as a covered employee for any year only if he or she is an officer on the last day of the year.

Thus, enactment of the change would eliminate use of a common structure whereby application of the \$1 million limit is avoided by deferring payment of compensation to the officer until after termination of employment. If the legislation is adopted in its current form, the changes would be effective for persons who become covered employees for years beginning after 2006.

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