

January 17, 2025

IRS Proposes Regulations Implementing Expansion of the Section 162(m) \$1 Million Deduction Limitation for Public Companies

Summary

On Tuesday, January 14, 2025, the Internal Revenue Service (IRS) and Treasury Department proposed regulations to implement statutory changes to Internal Revenue Code Section 162(m), as required by the American Rescue Plan Act of 2021.¹ The American Rescue Plan expanded the Section 162(m) annual \$1 million deduction limitation on publicly held corporations (“public companies”) to apply to compensation paid to the company’s “five highest compensated employees” for the taxable year, in addition to the compensation paid to executive officers (and other covered employees) that is already subject to the deduction limitation. This expansion of the limits on deductibility of compensation will become effective for taxable years beginning after December 31, 2026.

This Client Alert provides an overview of the proposed regulations.

Background

Section 162(m) has been in effect for over 30 years.² Last amended in 2017,³ Section 162(m) imposes a \$1 million annual tax deduction limit on compensation paid to each of a public company’s CEO, CFO and three other most highly compensated *executive officers*. These “covered employees” typically are the “named executive officers” (as determined under the Securities Exchange Act of 1934) for whom compensation is reported in the company’s annual proxy statement, although there can be variations in determining this group taking into account former executive officers, based on the specific IRS guidance. Beginning in 2017, if an executive is designated as a covered employee for whom compensation is not deductible over \$1 million, such individual continues to remain a covered employee for future years (a “once in, always in” concept).

¹ The American Rescue Plan Act of 2021, Pub. L. 117–2 § 9708 (Mar. 11, 2021).

² Omnibus Budget Reconciliation Act of 1993, Pub. L. 103–66 § 13211 (Aug. 10, 1993).

³ In 2017, the Tax Cuts and Jobs Act, Pub. L. 115–97 § 13601 (Dec. 22, 2017), amended Section 162(m) by (i) expanding the group of affected corporations to include those required to file reports under Section 15(d) of the Securities Exchange Act of 1934, so that it includes not only issuers of public equity but also, for example, foreign companies publicly traded through American Depository Receipts and issuers of public debt, (ii) eliminating the original law’s important exceptions to the \$1 million deduction limit for performance-based and commission compensation and (iii) expanding the group of “covered employees” to (A) include the public company’s CFO and (B) impose a “once in, always in” concept on the expanded group of covered employees, such that the covered employees for each year remain covered employees indefinitely (including post-employment).

In 2021, the American Rescue Plan further expanded a public company's covered employees to include its "five highest compensated employees" for the taxable year, regardless of whether those individuals are executive officers. This group is in addition to the CEO, CFO and three other most highly compensated executive officers, and for this added group, the "once in, always in" concept does not apply. The proposed regulations would implement these changes to Section 162(m) by clarifying how a public company determines its five highest compensated employees each year.

Determining the Five Highest Compensated Employees

Covers employees, not just executive officers. Any employee of a public company (including certain members of the company's affiliated group, discussed later) may be one of the five highest compensated employees for a taxable year, regardless of whether that employee is an executive officer. The proposed regulations would define "employee" by reference to the income tax withholding rules. Generally, this means the company's common law employees and officers. A third party used to employ or pay compensation to employees for services provided to the company (e.g., a certified professional employer organization or a related entity that is not in the company's affiliated group) would be disregarded. Consultants would also not be covered.

A public company generally will need to identify at least 10 covered employees for each taxable year, for whom a deduction is disallowed for compensation over \$1 million:⁴ the five executive officers who have historically been covered by the rule, and the next five highest compensated employees, whose status as covered employees is determined under the proposed regulations. The actual number of employees to which the deduction limitation will apply could be higher since the executive officer group may be larger based on the "once in, always in" rule applicable to that group. Anyone who is a covered employee for the taxable year as a *current* executive officer cannot also be one of the company's five highest compensated employees. However, a *former* executive officer who is already a covered employee based on "once in, always in" also may be one of the company's five highest compensated employees for the taxable year.

Defining "Compensation"

Determining the group of five highest paid employees is based on who has the highest taxable income. The proposed regulations clarify that in determining the five highest compensated employees, "compensation" means taxable compensation for the year for which the deduction limitation would otherwise apply. Generally, this should align with the amount reportable on the individual's Form W-2, Box 1, for the taxable year,⁵ and companies should already be tracking these amounts for tax deduction and reporting purposes. This is a departure from the methodology used for determining which executive officers are subject to the limits on deductibility, which is determined based on the SEC rules for the disclosure of compensation in the proxy. The IRS reached the conclusion they could have two different standards because the definition of "five highest compensated employees" in the American Rescue Plan does not reference determinations under securities law compensation disclosure requirements—in contrast to the statutory requirements for determining the three highest compensated executive officers under the current regulations.

Testing Compensation at Public Companies in an Affiliated Group

Consistent with the pre-American Rescue Plan regulations, if there is only one public company in an affiliated group of companies, then all employees of any member of the group would be treated as employees of the public company, regardless of whether the individual provides services specifically to the public company (or to another member of the affiliated group).

Under the proposed regulations, if there is more than one public company in an affiliated group, then the five highest compensated employees of the "parent corporation" and each "additional publicly held corporation" would be tested separately

⁴ If more than one person serves as CEO or CFO in a year, then each such person is treated as a covered employee, expanding the number of covered employees identified for the year.

⁵ Certain fringe benefits may be deductible as compensation but excludable from the employee's W-2, Box 1 reporting.

based on the compensation treated as paid by each. The parent corporation is the highest corporation in the chain (or chains) of includible corporations that comprise the affiliated group. If more than one affiliated group member may be the parent corporation (such as a group in which a common parent that is not publicly held owns multiple publicly held corporations), then the affiliated group would choose which member to treat as the parent corporation for the taxable year, and the other would be treated as an additional publicly held corporation.

In determining the compensation paid by each public company within the affiliated group, the proposed regulations would treat each group member as part of the affiliated group of only one public company within the larger affiliated group. For an additional publicly held corporation, only a group member below it in the chain of ownership would be treated as a member of its affiliated group (unless that group member is treated as a member of the affiliated group of a second additional publicly held corporation lower in the chain of ownership). Any group member not treated as a member of an additional publicly held corporation's affiliated group under these rules would be treated as a member of the parent corporation's affiliated group. Each public company within the affiliated group would only test the individuals treated as employees of, and the compensation treated as paid by, such company pursuant to these rules.

If an employee provides services to two or more public companies in an affiliated group, the proposed regulations would apply the proration rules that already apply for purposes of allocating the deduction limitation among such public companies. The amount disallowed as a deduction would be allocated to each public company based on the amount of compensation each public company (or member of its modified affiliated group) paid to the employee.

The proposed regulations also add an anti-abuse rule for purposes of allocating income to a controlled foreign corporation within an affiliated group.

Practice Pointers

Public companies and private companies anticipating a future public offering should consider Section 162(m) when structuring deferred compensation, cash or equity-based incentive, severance and similar arrangements for employees who potentially could be among the company's five highest compensated employees at the time of payment.

- Cliff—or lump sum—payment events in one year could make an employee more likely to be among the five highest compensated for the taxable year in which the compensation is potentially subject to the Section 162(m) deduction limitation (though deferral of compensation would make an employee less likely to be among the top five highest compensated employees for the taxable year during which the deferred compensation would have been paid had it not been deferred).
- For example, a large signing bonus payable by a public company in a single year would make the employee likely to be among the five highest compensated employees for that year, and so would be nondeductible to the extent it exceeds \$1 million; but the same amount structured as a series of annual payments would make it less likely that the employee is among the five highest compensated employees in any year, and the employer would benefit from the reset of the \$1 million deductibility threshold in each year paid.
- Similarly, a private company employee equity plan structured to pay upon an initial public offering likely would result in amounts being subject to the deduction limitation, but the effect could be mitigated by deferring payment of some of the largest awards to one or more future taxable years.

Note that currently outstanding equity awards or deferred compensation arrangements may already have significant payments scheduled to be made in calendar year 2027 (and/or later years), and so should be taken into account when considering future compensation planning for employees who might potentially be among the five highest compensated employees in such future year(s).

Effective Date

The proposed regulations will apply for any taxable year beginning after the later of December 31, 2026, or the date of publication of the final regulations in the Federal Register.

Request for Comments

The IRS and Treasury Department specifically requested comments on the application of the proposed regulations to controlled foreign corporations, and whether these proposed regulations should apply to controlled foreign corporations that are not members of an affiliated group. Comments on this and any other issues presented by the proposed regulations must be submitted by March 17, 2025.

We will continue to monitor these developments. If you have questions, please contact any of the undersigned.

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This memorandum is not intended to provide legal or tax advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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