



BENEFITS & COMPENSATION UPDATE

IRS PROPOSES REGULATIONS IMPLEMENTING AN EXPANDED DEFINITION OF “COVERED EMPLOYEE” UNDER CODE SECTION 162(m)

The IRS and the Department of the Treasury published a notice of proposed rulemaking on January 16, 2025 ([REG-118988-22, 90 Fed. Reg. 4691](#)), implementing an amendment to Section 162(m) of the Internal Revenue Code (“Code”) made by the American Rescue Plan Act of 2021 (“ARPA”).

The new proposed regulations implement the changes made by the amendment to the definition of “covered employee” under Section 162(m), effective for tax years beginning after December 31, 2026. The current definition of “covered employee” remains in effect until the proposed regulations’ effective date.

BACKGROUND

Section 162(m) was enacted as part of the Omnibus Budget Reconciliation Act of 1993 and subsequently amended by the Tax Cuts and Jobs Act of 2017 (“TCJA”). It applies to publicly held corporations and limits deductions for any year relating to compensation paid to certain employees to \$1 million per employee.

The definition of publicly held corporation includes any corporation for Federal tax purposes that has issued securities (not necessarily stock) required to be registered under the Securities Exchange Act of 1934 (the “Exchange Act”), or that is required to file reports under Section 15(d) of the Exchange Act.

Under regulations, a publicly held corporation for purposes of Section 162(m) includes an “affiliated group” (generally as defined in Code Section 1504) of corporations that includes one or more publicly held corporations. Each publicly held corporation that is a

member of an affiliated group is separately subject to Section 162(m).

The ARPA amendment expanded the definition of “covered employee” under Section 162(m), and the proposed regulations published on January 16, 2025, implement that amendment, effective for tax years beginning after December 31, 2026.

EXPANDED DEFINITION OF “COVERED EMPLOYEE” UNDER SECTION 162(m)

As amended by TCJA, Section 162(m) currently limits a publicly held corporation’s deductions to \$1 million for compensation paid with respect to each of the following covered employees of the corporation (the “current covered employees”): (1) the principal executive officer (“PEO”); (2) the principal financial officer (“PFO”); (3) the three highest paid executive officers other than the PEO and PFO; and (4) any employee determined to be a “covered employee” in any preceding taxable year, effective (in general) for tax years beginning after December 31, 2017.

Under the proposed regulations, the term “covered employee” will also include a publicly held corporation’s five highest compensated employees other than the PEO, the PFO, and the three highest paid executives other than the PEO and PFO (the “additional covered employees”). The additional covered employees are identified based on the amounts paid to them as compensation that would be deductible but for Section 162(m).

Importantly, the additional covered employees are determined for each tax year and will not necessarily be considered covered employees for subsequent tax years; in other words, the additional covered employees are not within the “once a covered employee, always a covered employee” rule as introduced by TCJA with respect to the current covered employees. Advantageously for employers, an employee who is a covered employee under the “once a covered employee, always a covered employee” provision may also be one of the additional covered employees under the proposed regulations.

The proposed regulations provide that the term “employee” includes common law employees as well as officers of a corporation (consistent with the definition of “employee” in Code Section 3401(c) and the regulation thereunder), such that an “employee” may include, for example, an individual employed by a person other than a publicly held corporation, where substantially all of the individual’s services are provided to a publicly held corporation.

An employee of any member of an affiliated group that includes a publicly held corporation may be a covered employee regardless of whether the employee is directly employed by the publicly held corporation itself or provides any services to that corporation. Additionally, if an employee is compensated by more than one member of an affiliated group that includes a publicly held corporation, the compensation paid in respect of that employee by all members will be aggregated to determine whether the employee is a covered employee.

CONSIDERATIONS RELATED TO COMPENSATION PAID BY PARTNERSHIPS AND FOREIGN CORPORATIONS WITHIN AFFILIATED GROUPS UNDER SECTION 162(m)

The proposed regulations include an example illustrating a situation in which a partner’s distributive share of a partnership expense is considered compensation for purposes of determining whether an employee is a covered employee (a concept already reflected in the

current regulations for purposes of applying the deduction limitation). In the proposed regulations’ Example 29, the compensation taken into account to determine whether an executive officer of a publicly held corporation within an affiliated group is a covered employee of the group includes compensation received from a partnership of which the publicly held corporation is a partner and for which the executive officer performed services. The executive officer’s compensation from the partnership that is taken into account for purposes of Section 162(m) will be an amount equal to the publicly held corporation’s distributive share of the partnership’s deduction for such compensation expense.

In addition, the proposed regulations indicate that the compensation paid by a controlled foreign corporation (“CFC”) within an affiliated group that may be taken into account for purposes of the deduction limitation includes compensation related to income of the CFC that is effectively connected with a U.S. trade or business, and compensation properly allocable to income that would be includable in gross income under provisions of the Code relating to subpart F income and GILTI. The notice of proposed rulemaking specifically requests comments regarding the application of the proposed regulations to CFCs.

NEXT STEPS

The IRS and the Department of the Treasury will accept comments on the proposed regulations through March 17, 2025. Whether the issuance of these proposed regulations in final form will be affected by recent Executive Orders of the President remains to be seen. If the proposed regulations are ultimately issued in final form, they will require publicly held corporations to take additional steps to determine their covered employees under Section 162(m) for tax years beginning after December 31, 2026. Given the multi-year structure of many compensation arrangements for executives and other highly paid employees, consideration of the impact of the ARPA changes should begin well before that effective date.

This update is not intended to provide legal advice with respect to any particular situation, and no legal or business decision should be based solely on its content.

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