ALERT
Viewpoint on Executive Compensation

COVID-19 Stimulus Bill Expands Covered Employees Subject to Section 162(m) Tax Limits

- JOHN ELLERMAN

Introduction

Section 162(m) of the Internal Revenue Code (IRC) became effective in 1994. The intent of Section 162(m) was to limit the tax deductibility of compensation paid to the "covered employees" of publicly traded companies that was in excess of $1 million per year. Section 162(m) initially provided for an exemption for qualified performance-based compensation such as performance-based incentive plans that received shareholder approval and satisfied other performance criteria.[1]

In December 2017, Congress passed — and President Donald Trump signed — the Tax Cuts and Jobs Act of 2017, which included certain amendments to Section 162(m). These amendments eliminated the exemption for performance-based compensation and expanded the scope of individuals who may qualify as covered employees subject to the $1 million annual compensation limitation deductibility. The covered-employees provision of the IRC Section 162(m) was expanded to include the CFO position in addition to the CEO and the three other highest-compensated executive officers during the applicable year.[2] On December 18, 2020, the Treasury Department and Internal Revenue Service issued final regulations regarding the amendments made to Section 162(m) created by the Tax Cuts and Jobs Act of 2017.

COVID-19 Stimulus Legislation Expands Section 162(m) Coverage

In early March 2021, Congress passed — and President Joe Biden signed — the American Rescue Plan Act of 2021 (the "Act"), which is a $1.9 trillion economic stimulus bill. Designed to provide economic relief to the American people during the COVID-19 pandemic, primarily through the tax code in the form of stimulus payments, expanded employment benefits, and expansion of the child tax credit.

One of the lesser-known provisions of the Act is an expansion of the number of covered employees subject to the Section 162(m) compensation deduction limits. The Act specifies that for any taxable year beginning after December 31, 2026, the covered employees will include the company's five highest-compensated employees for that year in addition to the CEO, CFO, and three other highest-compensated officers. As a result, the company will only be able to deduct $1 million in annual compensation expense for each of its ten highest-paid employees for the applicable fiscal year beginning in 2027. However, the five additional

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employees will not be treated as covered employees for all years thereafter and must be redetermined each year.[3]

Because the impact of this tax law change is five years into the future, most U.S. companies have not yet fully assessed the economic consequences of its potential impact.

General questions about this Viewpoint can be directed to John Ellerman at john.ellerman@paygovernance.com.

1. Jean M. McLoughlin and Ron M. Aizen. "IRS Guidance on Section 162(m) Tax Reform. Harvard Law School Forum on Corporate Governance. September 26, 2018. https://corpgov.law.harvard.edu/2018/09/26/irs-guidance-on-section-162m-tax-reform/.

2. Regina Olshan et al. "IRS Issues Final Regulations Under Section 162(m)." Skadden. December 23, 2020. https://www.skadden.com/insights/publications/2020/12/irs-issues-final-regulations-under-section-162m.

3. Ira M. Golub et al. "New COVID-19 Stimulus Bill Includes Significant Pension Reforms and Expands Scope of 162(m) Compensation Deduction Limit." The National Law Review. March 10, 2021. https://www.natlawreview.com/article/new-covid-19-stimulus-bill-includes-significant-pension-reforms-and-expands-scope.