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This Washington Report is prepared exclusively for Finseca Influencer members by Jim Earle, Partner at Troutman Pepper Locke.

New Section 162(m) Deduction Limits Coming in 2027

MARKET TREND: IRS proposed regulations published in January 2025 provide additional guidance related to expanded tax deduction limits on compensation paid by publicly held corporations to certain highly paid employees. The new rules become effective for tax years beginning after December 31, 2026.

SYNOPSIS: The 2021 COVID-19 stimulus act, the American Rescue Plan Act of 2021, includes an amendment to Section 162(m) of the Internal Revenue Code to expand the group of employees subject to the Section 162(m) limit on tax deductions for compensation. Before this amendment, Section 162(m) applied to compensation paid for a publicly held corporation's CEO, CFO, and next three highest paid executive officers. As amended, Section 162(m) will also apply to the five other highest paid employees for a taxable year, including non-executive employees. Compensation received by any of those five highest paid employees for a year over $1 million will not be tax deductible for tax years beginning after December 31, 2026. The proposed regulations address details for these new rules, including clarifying that the rules apply to employees of the publicly held corporation and its affiliates, applying the new rules to compensation paid to certain non-employees who function as employees by providing substantially all of their services to the publicly held corporation, and defining the compensation to be used for identifying the five highest paid employees each year. This article explores the requirements of this new rule as explained in the proposed regulations and considers limited planning opportunities related to the new rules for the design of certain compensation plans, including non-qualified deferred compensation plans.

TAKE-AWAYS: A The new Section 162(m) rules may have design implications for compensation arrangements that can cause large, lumpy taxable events, such as stock option programs or non-qualified deferred compensation plans with in-service payments or lump sum payments at termination of employment. While the new rules provide few planning opportunities to mitigate the potential lost tax deductions, there may be a few design opportunities for stock option programs or non-qualified deferred compensation plans to reduce the adverse tax results for companies. Implementing the new rules will require coordinated efforts and advanced planning by key stakeholders, including HR, payroll, tax, and legal.

A BRIEF HISTORY OF SECTION 162(M)

The American Rescue Plan Act of 2021 ("ARPA")[1] was one of a series of COVID-19 stimulus bills. To help pay for that stimulus, ARPA amended Section 162(m) of the Internal Revenue Code of 1986, as amended ("Section 162(m)") to expand the deduction limit on compensation paid by publicly held corporations for tax years beginning after December 31, 2026. This article explains the scope of those new limitations based on IRS proposed regulations published in January 2025 (the "proposed regulations")[2], including potential impacts on nonqualified deferred compensation ("NQDC") plans.

To better set the context for these new rules, we want to provide a refresher on the history of Section 162(m). As illustrated through this history, Section 162(m) began as a half-hearted attempt to limit executive compensation. It has evolved through the years, however, to become a politically expedient source of increased tax revenues to help offset reduced tax revenues from tax cuts or increased federal expenditures in other legislative initiatives.

Section 162(m) was introduced in 1993 as part of the Omnibus Budget Reconciliation Act of 1993 to address concerns over excessive executive compensation in publicly held corporations.[3] The provision was intended to curb the practice of providing large salaries and bonuses to top executives by limiting the tax deductibility of such compensation. In its original formulation, Section 162(m) limited the deductibility of compensation paid to the year-end CEO and the next four highest-paid executive officers of a publicly held corporation to $1 million per year.[4] But this deduction limit included a large exception for "performance-based compensation" as uniquely defined under Section 162(m). The performance-based compensation exception applied to most stock options and was easily applied to many cash bonus programs and performance-vesting equity awards. The limitation also applied solely to the individuals serving in the covered employee roles as of the end of the applicable tax year, meaning that any deferred compensation payable after termination of employment escaped the deduction limit. Between the performance-based compensation exception and the year-end employment requirement, the original formulation of Section 162(m) rarely resulted in significant lost tax deductions – mainly just for non-deferred salary paid in excess of $1 million.

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[1]Pub. L. 117-2, 135 Stat. 4, 206 (2021).
[2]REG-118988-22, 90 Fed. Reg. 4691, *Certain Employee Remuneration in Excess of $1,000,000 under Internal Revenue Code Section 162(m)* (Jan. 16, 2025) (available [here]).
[3]Pub. L. 103-66, 107 Stat. 312, 469 (1993).
[4]The Section 162(m) "covered employee" definition was originally intended to follow Securities and Exchange Commission ("SEC") rules identifying those executive officers whose compensation was required to be disclosed by public companies. The SEC rules later changed to require disclosure of the CEO, CFO, and next three highest paid year-end executive officers, but the Section 162(m) statutory language was not changed. As a result, the IRS interpreted Section 162(m) as applying to the year-end CEO and next three highest paid executive officers, and not the CFO.

In 2008 and 2010, Section 162(m) was amended to create special rules intended to increase tax revenues to pay for certain legislative initiatives. First, in 2008 in connection with the global financial crisis, the Emergency Economic Stabilization Act of 2008 ("EESA") established the Troubled Assets Relief Program ("TARP").[5] EESA added a new Section 162(m) deduction limit applicable to financial institutions that received financial assistance under TARP. The deduction limit was set at a lower level ($500,000) with no performance-based compensation exception and continued applicability to compensation earned in a covered year that is deferred and payable in a later year. This rule no longer applies now that the TARP program is over. Then, in 2010 in connection with the Patient Protection and Affordable Care Act ("ACA"), Section 162(m) was amended to add a $500,000 compensation deduction limit applicable to certain covered health insurance providers, structured like the TARP limit, i.e., without a performance-based compensation exception and applicable to compensation earned in a given year even if deferred and payable in a later year.[6] This ACA limit continues to apply.

Then in 2017, the original Section 162(m) deduction limit underwent a massive overhaul as part of the Tax Cuts and Jobs Act ("TCJA").[7] The overhaul aimed to significantly expand the deduction limit, including by eliminating the performance-based compensation exception and creating a new "once a covered employee, always a covered employee" rule that eliminated the exception for payments of post-employment deferred compensation. The following chart summarizes the key changes made to Section 162(m) by the TCJA, comparing Section 162(m) as in effect before the TCJA ("old" Section 162(m)) to the new rules applicable under the TCJA beginning in 2018 ("new" Section 162(m)).[8]

Feature	Old Section 162(m) (pre-2018)	New Section 162(m) (beginning 2018)
Covered Companies	- Any "publicly held corporation," meaning a corporation with a class of common equity securities required to be registered under §12 of the '34 Act	- Expanded to include companies that are required to file reports under §15(d) of the '34 Act, such as certain foreign issuers of ADRs or issuers of public debt
Covered Employees	- The year-end CEO and the top-3 other year-end highest paid executives whose compensation is required to be reported in the proxy statement under SEC rules - Does not include the CFO - Year-by-year determination (i.e., does not apply if not in the position at year-end)	- Anyone who served as CEO or CFO during the year (not just year-end) - Top-3 other highest paid executives whose compensation is required to be reported in the proxy statement under SEC rules (or would be if those rules applied), regardless of year-end status - Will be considered a covered employee for the year of determination and each year thereafter, including individuals determined as covered employees under old Section 162(m) for 2017
Compensation Excluded from Deduction Limit	- The deduction limit does not apply to compensation that qualifies as "commissions" or "performance-based"	- No exceptions

[5]Pub. L. No. 110-343, Div. A, §101(a) (2008).
[6]Pub. L. No. 111-148, §9014 (2010).
[7]Pub. L. 115-97, 131 Stat. 2054, 2155 (2017).
[8]The TCJA includes special grandfathering rules to determine whether compensation earned under written binding contracts entered before the TCJA remain subject to old Section 162(m) or become subject to the expanded rules under new Section 162(m).

EXPANDED DEDUCTION LIMITS BEGINNING 2027

With ARPA, Congress again turned to Section 162(m) to raise tax revenues as a partial offset to costs of the ARPA stimulus benefits. ARPA adds a new category of Section 162(m) covered employees ("ARPA covered employees") who need not be executive officers. The proposed regulations are intended to clarify the operation of these new requirements.

Which Employees are ARPA Covered Employees? The new category of ARPA covered employees means any "employee" who is among the five highest compensated employees for the taxable year, other than the CEO, CFO, or the three highest compensated year-end executive officers already considered a Section 162(m) covered employee. "Employee" means any common law employee, regardless of whether an executive officer. Importantly for the discussion below, an employee can be an ARPA covered employee even if the individual terminates employment before the end of the applicable tax year. A former employee who performed no services for the publicly held corporation or its affiliates during a taxable year, however, should not qualify as an ARPA covered employee, even if the former employee received large amounts of post-employment taxable compensation in a year after the year of termination, such as from NQDC payments or post-employment stock option exercises.[9]

The proposed regulations address concerns that publicly held corporations might employ highly compensated employees at subsidiaries to avoid the deduction limitation. Therefore, the regulations provide that any employee of any corporation in a publicly held corporation's affiliated group may be one of the five highest compensated employees of the publicly held corporation, regardless of whether the employee performs services for the publicly held corporation itself. The proposed regulations also include specific rules for addressing situations where an affiliated group includes a controlled foreign corporation and where more than one publicly held corporation is a member of the affiliated group.

The proposed regulations also apply the deduction limit to individuals who function as employees by providing substantially all of their services to a publicly held corporation even though not as an employee of the publicly held corporation or one of its affiliates.[10] This fact pattern can arise, for example, with a publicly traded real estate investment trust that has externalized its management through a services agreement with an unaffiliated entity, or for an individual engaged in services as a dedicated consultant not providing substantial services to other clients.

The ARPA covered employee group is determined separately for each applicable tax year, and unlike the other categories of covered employees, is not subject to the "once a covered employee, always a covered employee" rule.

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[9]The proposed regulations are not entirely clear on this point, but this conclusion seems reasonable based on similarities with the statutory and regulatory language for describing the next three highest paid executive officers.
[10]This category should not include an individual providing services solely as a non-employee director.

What Compensation is Used to Determine the ARPA Covered Employees? For purposes of determining the five ARPA covered employees, the proposed regulations define "compensation" as compensation that would otherwise be deductible for the taxable year but for Section 162(m), whether or not services were performed during that taxable year. This is a different compensation definition than the one used to determine Section 162(m) covered employee status based on being one of the three highest compensated executive officers for the year, which is based on the SEC's definition of compensation for disclosure purposes.[11] The IRS commented that this approach should be easily administrable because companies currently track compensation to determine their tax liability for the tax year. However, the proposed regulations do not address how to treat compensation that is not deductible by the corporation (such as amounts related to incentive stock options).

As discussed further below, this compensation definition also means that the group of ARPA covered employees can vary year-to-year based on factors such as decisions to defer compensation under NQDC plans, to receive scheduled in-service payments under NQDC plans, or other periodic large taxable events from equity award vesting, the exercise of nonqualified stock options, or the receipt of sign-on bonuses, retention awards or other special compensation opportunities.

In the case of individuals who are not employees of the publicly held corporation or its affiliates but who function as an employee by providing substantially all of their services to the publicly held corporation or its affiliates (e.g., in case of externally managed companies, certain consultants, or individuals retained through professional employer corporations), payments made to the unaffiliated company to "obtain the services" of the individual will be treated as compensation to the individual for these purposes, regardless of the year that the services were performed.

Interplay Between ARPA Covered Employees and Other Covered Employees. The group of five ARPA covered employees is required to be different than the individuals who are Section 162(m) covered employees by reason of serving during the taxable year as the CEO or CFO or by reason of being one of the other three highest paid executive officers for the taxable year. But an individual who is a Section 162(m) covered employee only because they had been in one of those categories in a prior year (i.e., because of the "once a covered employee, always a covered employee" rule) may also be an ARPA covered employee.

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[11] For example, compensation for SEC disclosure purposes includes the accounting grant date fair value of equity awards granted during the year, and not the amount realized for equity awards upon vesting or exercise.

A couple of examples illustrate this interplay of the rules. Assume for these examples that Public Company X has a single CEO and CFO, and five other executive officers (EOs 1-5).

- Example 1 (no ARPA covered employee overlap). Assume in 2027 that EOs 1, 2 and 3 are the three highest paid executive officers for the year, and EOs 4 and 5 have never been a Section 162(m) covered employee in a prior year. Also assume that the five highest paid employees for 2027 (based on 2027 taxable compensation) other than the CEO, CFO and EOs 1-3 are EOs 4 and 5 plus the top three paid non-executive employees. In this case, EOs 4 and 5 plus those top three paid non-executive employees are ARPA covered employees, and if any of those five individuals received taxable compensation for 2027 in excess of $1 million, that compensation over $1 million is not tax deductible. But EOs 4 and 5 and the top three paid non-executive employees for 2027 will not necessarily be Section 162(m) covered employees for 2028 or later. The group of ARPA covered employees will be separately determined for 2028 based on 2028 taxable compensation without regard to prior year determinations.

- Example 2 (ARPA covered employee overlap). Assume the same facts as in Example 1, except that EO 4 was a Section 162(m) covered employee for 2026 by reason of having been one of the top three paid executive officers for 2026. The group of ARPA covered employees for 2027 is the same as described in Example 1 – i.e., EOs 4 and 5 plus the next three highest paid non-executive employees. However, EO 4 was already required to be a Section 162(m) covered employee for 2027 due to the "once a covered employee, always a covered employee" rule. As a result, for 2027, only four "new" covered employees are added to the deduction limit – i.e., EO 5 and the next three highest paid non-executive employees for the year. The fourth highest paid non-executive employee is not required to be added to the 2027 ARPA covered employee group.

Effective Date. The ARPA change to Section 162(m) applies to tax years beginning after December 31, 2026. The proposed regulations generally become effective at the later of the ARPA effective date or the date of publication of final regulations in the Federal Register. Given the current environment of reduced staffing and deregulatory initiatives, it is unclear if and when the proposed regulations will be finalized.

WILL THESE NEW RULES IMPACT NQDC PLANS OR OTHER COMPENSATION PLANS?

For public companies with numerous employees receiving annual compensation over $1 million, the new ARPA covered employee rules will clearly reduce tax deductions. But even for companies where non-executive employees generally do not receive over $1 million in annual compensation, the new rules could trigger lost tax deductions if any of that compensation can be received in aggregated "lumps," such as payments under NQDC plans or taxable compensation from stock option exercises, equity award vesting, retention awards, sign-on bonuses, or other types of one-time taxable pay.

For example, consider a highly paid non-executive employee who participates every year in a company's NQDC plan. The employee never received more than $1 million of taxable pay in any given year, in part due to the employee's decision to defer compensation into the NQDC plan. Even if the employee had been an ARPA covered employee in any of those years, the company would not have lost any tax deductions given the employee's compensation was less than $1 million. If, however, the NQDC plan includes a lump sum payout immediately after termination of employment, the employee's lump sum payout at employment termination could cause the employee to be an ARPA covered employee for that year and trigger the deduction limit, especially if the years of deferring compensation results in a large accumulated NQDC plan account balance that is distributed. A similar effect could occur if the employee had received non-qualified stock options and waits until termination of employment to exercise the options, especially if the options have a large taxable spread value at exercise.

Given this dynamic, publicly held corporations with NQDC plans may want to consider requiring NQDC plan lump sum payments at termination of employment to be made early in the year following the year of termination of employment. In that case, the amount should be fully deductible without regard to the ARPA covered employee rules for any former non-executive employees (or any former executive officers who had never been a covered employee under any of the other Section 162(m) covered employee categories).[12] Publicly held corporations may also want to look for other ways to cause otherwise non-deductible compensation for potential ARPA covered employees to be paid in the year after termination of employment.

[12]Any such design changes to an existing NQDC plan likely must be prospectively effective for future deferrals given the restrictions under Section 409A of the Internal Revenue Code.

WHAT SHOULD EMPLOYERS DO NOW?

Unfortunately the Section 162(m) rules as amended by the TCJA and ARPA provide little room for other planning opportunities to reduce or avoid lost tax deductions. For the new ARPA covered employee rules, publicly held corporations should start now to establish a compliance system to identify the ARPA covered employees each year starting in 2027. Compliance likely requires coordination among key stakeholders within the company, including HR, payroll, tax, and legal.

The compliance burden for many companies may not be significantly more cumbersome than applying the current Section 162(m) rules. By requiring the group of ARPA employees to be identified each year based on taxable wages for the year (i.e., box 1 W-2 wages for employees), the additional effort likely requires a stack ranking of employees for the year based on those taxable wages, and then backing out the Section 162(m) covered employees who are in by reason of having served as CEO or CFO, or who are one of the three other highest paid executive officers for the year. The next five highest paid employees will be the ARPA covered employees. Care should be taken to ensure that all employees of the publicly held corporation's affiliated group are included and to identify whether any non-employees who provide substantially all of their services to the publicly held corporation need to be considered. Additional administrative complexity applies if the publicly held corporation needs to consider compensation paid by affiliated controlled foreign corporations or if there is more than one publicly held corporation within the affiliated group.

For those companies that may lose tax deductions related to the ARPA covered employees, consideration can be given to whether tax deductions can be better preserved through changes to compensation arrangements, such as spreading compensation over tax years or delaying payments until the year after termination of employment. But apart from these limited planning opportunities, the main action items will be monitoring the finalization of the proposed regulations and readying for compliance in 2027.