

IRS releases proposed regulations for Section 162(m)'s expanded covered employees

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The IRS released proposed regulations pertaining to the Section 162(m) limits on the deduction for certain employee remuneration in excess of \$1 million. The proposal provides for the identification of an expanded group of public company covered employees and the allocation of compensation within a company's affiliated group.

On January 14, 2025, the IRS released [proposed regulations](#) under Section 162(m) of the Internal Revenue Code, which limits the deduction for certain employee remuneration in excess of \$1 million for federal income tax purposes.

Background

Prior to the American Rescue Plan Act of 2021,¹ Section 162(m) of the Internal Revenue Code generally prohibited publicly held companies from deducting more than \$1 million in compensation paid to current or former "covered employees" in a taxable year. This generally included the company's "named executive officers" for the taxable year (as determined under the applicable disclosure rules of the Securities Exchange Act of 1934) and, under a "once a covered employee, always a covered employee" rule, anyone who was a named executive officer at any time beginning in 2017. However, the ARPA expanded the group of individuals considered to be "covered employees" under Section 162(m) to include the company's next five highest compensated employees in that year, regardless of whether they are officers, effective for taxable years beginning after December 31, 2026.

Determining covered employees

The proposed regulations are intended to clarify who qualifies as an employee under Section 162(m) and how compensation will be calculated in order to determine whether an employee will qualify as a "covered employee" under Section 162(m).

Determining eligible employees. The proposed regulations provide that any common law employee or officer of the company will be considered an "employee" under Section 162(m). This includes not just employees of the publicly held company, but any employee of any member of the "affiliated group" of companies along with the publicly held company. Any individual who was an employee of the company during the applicable taxable year will be considered an "employee" for purposes of Section 162(m) regardless of whether such individual is employed on the last day of the taxable year.

For companies that engage employees through a professional employer organization or similar entity, the proposed regulations clarify that, as long as the employees are providing services to the company, then such employees will be treated as "employees" of the company under Section 162(m).

Determining covered employees. As noted above, in addition to the company's named executive officers, a company's "covered employees" will include the five highest compensated employees for the current taxable year. Unlike the existing Section 162(m) treatment of named executive officers, these additional highly compensated employees may change each year and will not be subject to the "once a covered employee, always a covered employee" rule.

In order to determine whether an employee is one of the five highest compensated employees and therefore is a "covered employee" pursuant to Section 162(m), the employee's compensation would be calculated based on the amount allowable as a deduction to the company (but for Section 162(m)) for compensation paid to the employee. This includes any remuneration received by the employee during the taxable year for services performed in any capacity, whether or not such services were performed during the taxable year, and any compensation received from any member of the affiliated group. This can include amounts that are includible in the income of, or paid to, a third party other than the applicable employee for services performed by the employee.

This method is intended to differ from the method used by publicly held companies for determining their named executive officers under the Exchange Act. While the IRS considered using that method, the IRS ultimately rejected that approach. Instead, the proposed rules allow for companies to use the more readily available methodology for determining the company's five most highly compensated employees. Therefore, companies do not need to expand their compensation analysis under the Exchange Act to cover additional employees in order to determine whether they are among the company's five highest compensated employees and thus covered employees under Section 162(m).

The proposed regulations permit a publicly held company to include individuals who were already among the company's covered employees by virtue of previously being a named executive officer for a prior taxable year among the five highest compensated employees for the current taxable year. Under the "once a covered employee, always a covered employee" rule, anyone who was a named executive officer at any time beginning in 2017 remains a covered employee even after they are no longer considered a named executive officer. The proposed regulations clarify that these individuals may also be included among the five highest compensated employees. Since these former named executive officers can count among the company's five highest compensated employees, this may result in fewer individuals being considered covered employees under Section 162(m).

This does raise questions about how certain forms of compensation that are either not currently deductible by the company or not deductible at all would be treated. For example, if compensation is deferred to a later tax year, under the proposed regulations such deferred compensation would not be taken into account until paid in determining whether an employee is one of the five highest compensated employees. In addition, many equity awards would not be deductible by the company until they are settled or exercised. Moreover, some forms of compensation are not deductible at any time by the company for U.S. federal income tax purposes (e.g., profits interests or incentive stock options where the optionholder does not have a disqualifying disposition). This could result in a disconnect between employees who are treated as the five most highly compensated employees and those that potentially receive greater compensation. The final regulations may address whether these items will be included.

In addition, for certain forms of compensation (e.g., annual bonus payments), to the extent there is flexibility in determining the year in which the deduction for such compensation would be taken under the applicable rules, companies may want to take Section 162(m) into account in making the determination since the proposed regulations only consider the amount subject to deduction in a given fiscal year.

Affiliated groups. The proposed regulations contemplate that each publicly held company will have its own list of five highly compensated employees, even if two or more publicly held companies are in the same affiliated group. If an employee is employed by a member of an affiliated group, and the affiliated group includes two or more publicly held companies, each publicly held company in the affiliated group would have its own list of covered employees. Therefore, even if an employee is employed by more than one publicly held company in an affiliated group, the employee would only be a covered employee for one of the publicly held companies in the affiliated group. The proposed regulations provide examples explaining how to determine to which smaller affiliated group such employee should belong.

In addition, compensation received by employees from non-U.S. members of an affiliated group will be taken into account when determining compensation. Compensation and other expenses that are taken as a deduction by a non-U.S. corporation may be disallowed by Section 162(m) if they are incurred in connection with a trade or business in the United States. Further, the proposed regulations contemplate that, if the member of the affiliated group is a non-U.S. corporation that is a "controlled foreign corporation," then the portion of deductions for compensation paid to employees that is taken into account in calculating the company's GILTI and Subpart F inclusions is taken into account when determining compensation for these purposes.

Notice period and final regulations

The IRS has requested comments on or before the date that is 60 days following publication in the Federal Register, which is anticipated to be January 16, 2025. No public hearing is scheduled at this time.

Next steps

In anticipation of the changes to Section 162(m), companies may wish to review their employee population and prepare initial determinations on who may qualify as a “covered employee.” Although the expansion of the covered employee group is not effective until 2027, certain long-term incentive awards that are currently outstanding will likely vest and be settled in 2027 or later.

- **Information gathering.** Companies should determine if there are any processes that need to be put in place in order to gather the necessary information for determining the covered employee group. This may be more difficult for companies with multiple payroll systems, so this process should begin soon in order to aggregate the necessary data.
- **Bonus deduction.** Companies will want to consider whether to take measures to accelerate bonus deductions into 2026 for those employees who are likely to become covered employees under the expanded definition. When Section 162(m) was amended in 2017, a number of companies took action to preserve the tax deductibility of compensation that would have been tax deductible under old Section 162(m).
- **Non-U.S. employees.** Companies with employees outside the United States should review their existing compensation policies to determine whether any such employees could be treated as covered employees.
- **PEOs.** Companies with employees employed by a PEO should reach out to their PEO to gather the necessary information for determining the highest compensated employees and establishing processes for gathering information in the future.
- **Ongoing developments.** Companies should also continue to monitor developments relating to the changes to Section 162(m) and consider commenting to address specific scenarios.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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¹ For additional information on the ARPA, please see our previous [client update issued on March 23, 2021](#).