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Is That Compensation Deductible? The Latest Guidance on the $1M Deduction Limit and the Ever-Expanding Definition of Covered Employees

Section 162(m) of the Internal Revenue Code, as amended (the "Code") is the law that limits the deductibility of compensation paid by publicly traded employers to $1 million per employee for a specific group of employees (called "covered employees"). Section 162(m) has been overhauled and tweaked many times in the last five years.

A quick refresher -- Section 162(m) was amended at the end of 2017 (in the "The Tax Cuts and Jobs Act" (TCJA)) to make substantial changes, including expanding the definition of public company, modifying the scope of covered employees, eliminating the performance-based compensation and commission exceptions, and exempting from the new rules certain "grandfathered plans".

One of the more substantial revisions adopted in the TCJA is that Section 162(m) now included in the definition of covered employee an individual who serves as (or in the capacity of) the CEO or CFO at any time during the tax year as well as the three next highest paid employees. This rule became effective in 2017 for calendar year taxpayers.

Regulations were finalized at the end of 2020 to further explain how the revised law will be applied. Among the items clarified in the final regulations is the fact that if an individual is a covered employee with respect to a corporation for a taxable year beginning after December 31, 2016, the individual remains a covered employee for all future years. Thus, an individual remains a covered employee with respect to compensation otherwise deductible for subsequent years, including for years during which the individual is no longer employed by the corporation (capturing deferred compensation) and years after the individual has died.

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Michael Best

Thus, based on the prior changes, public companies usually have at least five covered employees for any tax year – generally the CEO, CFO, and three highest paid officers as determined under the U.S. Securities and Exchange Commission (SEC) rules in a tax year – plus any partial year CEOs and/or CFOs and individuals previously identified as covered employees for any prior tax year beginning after December 31, 2016.

The American Rescue Plan Act (ARPA) signed into law this month further expands the breadth of the covered employee definition. The ARPA provides that Section 162(m) covered employees now include an additional "five highest paid employees" in addition to the existing covered employees (CEO, CFO, and the three highest paid executive officers) included in the Section 162(m) limitation. This provision is applicable for tax years beginning after December 31, 2026 (i.e., 2027 for calendar year taxpayers).

The addition of the five highest paid employees is not, on the face of the statute, part of the "once a covered employee always a covered employee" rule. Rather, this five highest paid employee test appears to be applicable on an annual basis. Stated another way, only the traditional five covered employees (CEO, CFO, and three highest paid officers) remain covered employees in all future years. We will, however, need to see how the Internal Revenue Service interprets this new group within the overall regulatory scheme that it has created around Section 162(m).

While the delayed effective date is welcome, and it provides some time for public companies to develop and implement new tracking rules, it does not solve the embedded Code Section 409A concerns.

A special Section 409A rules allows payments to be delayed at the election of an employer, to the extent that the employer reasonably anticipates that the payment would not be deductible under Section 162(m). Some plans expressly include this rule; however, such a plan provision is not required under the tax laws. That said, any payments delayed under this rule must be delayed until the employee's separation from service or to another year in which the payments would reasonably be determined to be deductible. Payments to all similarly situated employees are required to be treated on a reasonably consistent basis. Many employers removed these provisions at the end of the last year. If, however, the new covered employee group is not permanent, it may be advisable to reintroduce some version of the Section 162(m) delay rule under Section 409A.

It is not clear how the change in the covered employee definition impacts payments that, under the special deferral provision, are not permitted to be paid until they would be deductible. The TCJA provides no transition rule related to this provision; however, more guidance may be forthcoming before the 2027 effective date.

Related People

Michael Altman
Partner
mhaltman@michaelbest.com
T 414.225.4932

Carrie Byrnes
Partner
cebyrnes@michaelbest.com
T 312.596.5838

Joshua Erekson
Partner
jberekson@michaelbest.com
T 801.833.0505

Martin Tierney
Partner
mptierney@michaelbest.com
T 414.223.2533

Kevin Timken
Partner
kctimken@michaelbest.com
T 801.924.4124