Deloitte.

Deloitte Tax LLP | January 29, 2025

Treasury and IRS release proposed regulations on certain employee remuneration in excess of $1 million under section 162(m)

Tax Alert

Overview

On January 14, 2025, the Internal Revenue Service (IRS) released proposed regulations (REG-118988-22) (the "Proposed Regulations") to implement amendments to section 162(m) of the Internal Revenue Code[1] made by the American Rescue Plan Act of 2021 (P.L. 117-2) ("ARPA").[2] The ARPA amendment expanded the definition of a covered employee for taxable years beginning after December 31, 2026. These Proposed Regulations were published in the Federal Register on January 16, 2025, and provide rules to assist taxpayers in the determination of individuals included in the new category of covered employees under section 162(m)(3)(C), as amended by the ARPA. The Proposed Regulations are summarized below.

Background

Section 162(m) generally imposes a $1 million limit on the deduction allowable to a publicly held corporation for applicable employee remuneration paid to a covered employee. Significant changes to section 162(m) were made by the 2017 Tax Cuts and Jobs Act (P.L. 115-97) ("TCJA")[3] including expanding the definition of covered employee.[4]

Under section 162(m)(3), as amended and broadened under TCJA and ARPA, a covered employee is defined as any employee of the taxpayer if:

1. Such employee is the principal executive officer (PEO) or principal financial officer (PFO) of the taxpayer at any time during the taxable year, or was an individual acting in such a capacity;
2. The total compensation of such employee for the taxable year is required to be reported to shareholders under the Securities Exchange Act of 1934 ("Exchange Act") by reason of such employee being among the 3 highest compensated officers for the taxable year (other than any individual described in subparagraph (1));

3. In the case of taxable years beginning after December 31, 2026, such employee is among the five highest compensated employees for the taxable year other than any individual described in subparagraph (1) or (2); or
4. Such employee was a covered employee described in subparagraph (1) or (2) of the taxpayer (or any predecessor) for any preceding taxable year beginning after December 31, 2016.

The term "covered employee" includes any employee whose total compensation for the taxable year places the individual among the three highest compensated officers for the taxable year (other than any individual who is the PEO or PFO of the taxpayer at any time during the taxable year, or was an individual acting in such a capacity) even if the compensation of the officer is not required to be reported to shareholders under the Exchange Act[5].

Proposed Regulations

Definition of Employee

To determine whether an employee is one of the five highest compensated employees under section 162(m)(3)(C), the Proposed Regulations define an "employee" as an employee under section 3401(c). Section 3401(c) provides that an "employee" includes a common law employee and an officer of a corporation. Thus, both officers and non-officer employees are eligible to be covered employees for purposes of section 162(m)(3)(C).

Interaction with Once Covered, Always Covered Rule

The Preamble states that because the language in section 162(m)(3)(C) does not exclude employees identified in section 162(m)(3)(D) (under the once covered, always covered rule), employees who are covered employees under the once covered, always covered rule are not excluded from the definition of covered employee under section 162(m)(3)(C).

> ***Observation:*** The Proposed Regulations and Preamble confirm that if an employee is a covered employee due to the once covered, always covered rule under section 162(m)(3)(D), then any such employee may also be a covered employee under section 162(m)(3)(C). As a result, the number of covered employees due to the five highest compensated rule may not necessarily result in the addition of five more employees to the covered employee pool each tax year.

The Proposed Regulations also confirm that the highest five compensated employees under section 162(m)(3)(C) are not covered by the once covered, always covered rule. Thus, an individual who is a covered employee in one year solely by reason of being among the five highest compensated employees under section 162(m)(3)(C) will not be a covered employee in future years under the once covered, always covered rule.

Definition of Compensation

Under the Proposed Regulations, "compensation" for purposes of determining whether a particular employee is one of the five highest compensated employees under section 162(m)(3)(C) is defined by reference to Treas. Reg. § 1.162-33(c). This reference also defines "compensation" for purposes of determining the amount disallowed as a deduction for any covered employee. By contrast, the compensation used to determine the executive officers who are covered employees under section 162(m)(3)(A) and (B) is the compensation required to be disclosed under the Exchange Act ("SEC Reporting Compensation"). In the Preamble, the IRS and Treasury Department stated that they considered, but rejected, identifying the five highest compensated employees under section 162(m)(3)(C) based on SEC Reporting Compensation,

on the basis that section 162(m)(3)(C) does not include a reference to compensation disclosure requirements under the Exchange Act.

Affiliated Group Rules

Under Treas. Reg. § 1.162-33(c)(1)(ii), a publicly held corporation includes an affiliated group of corporations, as defined in section 1504 (without regard to section 1504(b)) (an "affiliated group") that includes the publicly held corporation. The Proposed Regulations provide that any employee of any member of the affiliated group may be one of the five highest compensated employees under section 162(m)(3)(C) regardless of whether the employee is an employee of the publicly held corporation or performs services for the publicly held corporation. The Proposed Regulations provide that compensation paid by each member of the affiliated group is aggregated to determine whether the individual is one of the five highest compensated employees. The Preamble to the Proposed Regulations explains that this rule is included in the Proposed Regulations due to the concern a publicly held corporation may alter the compensation of the five highest compensated employees by transferring highly compensated employees to subsidiaries or adopting a holding company structure.

> ***Observation:*** The Proposed Regulations and Preamble explicitly state that an employee does not have to be employed by, or perform services for, the publicly held corporation to be a covered employee under section 162(m)(3)(C) and may be an employee of any member of the affiliated group.

Determination of the Highest Five Compensated Employees

To determine the five highest compensated employees under section 162(m)(3)(C), compensation paid by all members of an affiliated group is aggregated, and the employees are ranked by the amount of compensation attributed to them.

The five highest ranked employees who are not a PEO or PFO for the year and who are not among the three highest compensated executive officers for the year are the five highest compensated employees for purposes of section 162(m)(3)(C) (even if any of these five highest compensated employees is already a covered employee under the once covered, always covered rule).

Affiliated Groups with Multiple Publicly Held Corporations

If an affiliated group includes two or more publicly held corporations, special rules apply to determine the five highest compensated employees of each publicly held corporation. Under these rules, the affiliated group is divided into subgroups based on the position of the publicly held corporations in the corporate structure. Generally, the publicly held corporation that is highest on the chain (or chains) of corporations that comprise the affiliated group is referred to as the "parent corporation," and each other publicly held corporation in the affiliated group is referred to as an "additional publicly held corporation." Each parent corporation and additional publicly held corporation has its own affiliated group comprised of the parent corporation or the additional publicly held corporation, as applicable, and any corporations that are not publicly held that are assigned to it under the Proposed Regulations. All corporations in an affiliated group with more than one publicly held corporation are assigned to one (but not more than one) parent corporation affiliated group or additional publicly held corporation affiliated group.

Within each parent corporation affiliated group and each additional publicly held corporation affiliated group, the five highest compensated employees are determined under rules similar as those that apply to affiliated groups with only one publicly held corporation. That is, an employee of any member of the parent corporation affiliated group or the additional publicly held corporation

affiliated group (whether or not the member is publicly held) is eligible to be among the five highest compensated employees, and compensation paid by each member of the parent corporation affiliated group or additional publicly held corporation affiliated group, as applicable, is aggregated.

> ***Observation:*** To determine the amount of compensation paid to an employee in a parent corporation affiliated group or an additional publicly held corporation affiliated group, only compensation from members of that parent corporation affiliated group or additional publicly held corporation affiliated group is aggregated. Compensation paid by companies outside of the parent corporation affiliated group or additional publicly held corporation affiliated group is not included. In other words, compensation paid by any member of an affiliated group is only counted once for purposes of identifying the five highest compensated employees of any publicly held corporation.

The eligible employees in each affiliated group are then ranked by the amount of compensation attributed to them, and the five highest compensated employees who are not a PEO or PFO for the year and are not among the three highest compensated executive officers for the year are the five highest compensated employees of the parent corporation affiliated group or additional publicly held corporation affiliated group for purposes of section 162(m)(3)(C).

Compensation Paid by a Controlled Foreign Corporation (CFC)

As defined under Treas. Reg. § 1.162-33(c)(3), "compensation" means the aggregate amount allowable as a deduction under section 162, without regard to section 162(m)(1). The Proposed Regulations would add an explicit rule to the definition of compensation regarding remuneration paid by a CFC that is a member of a publicly held corporation's affiliated group. The Preamble includes commentary that the rule is not a substantive change to the existing final section 162(m) regulations. The proposed rule would apply generally for purposes of section 162(m). Notably, the Preamble to Proposed Regulations specifies that such compensation should be taken into account to determine whether an individual is one of the five highest compensated employees for a given tax year.

As described above, for purposes of section 162(m), an affiliated group includes a foreign corporation. Compensation and other expenses of a foreign corporation normally may be taken as a deduction by a foreign corporation in computing its US income tax only if they are incurred in connection with a trade or business carried on in the United States. In this instance, section 162(m) could apply to amounts otherwise deductible under section 162. However, if the foreign corporation is a CFC, as defined in section 957, income is generally not subject to US income tax and compensation and other expenses are not deductible under section 162. Instead, a pro rata share of certain types of CFC income less associated deductions may be taken into account by a United States shareholder of the corporation under Subpart F, sections 951 through 965.

The Proposed Regulations would provide that "compensation" includes a publicly held corporation's pro rata share (as determined under the principles of sections 951(a)(2) and 951A(e)(1)) of the amounts that would be claimed by a CFC as properly allocable to gross income under the Subpart F and Global Intangible Low-Taxed Income (GILTI) regimes described in sections 951(a)(1) and 951A(a), respectively, for compensation expenses attributable to remuneration paid by a CFC to a covered employee of a publicly held corporation for services rendered by the covered employee.

Observation: Publicly held corporations should continue to monitor CFCs in their affiliated group to 1) identify current and potential section 162(m) covered employees (including the five highest compensated employees) and 2) consider the impact of compensation paid by a CFC for Subpart F income and GILTI purposes.

Payments for Individuals Performing Substantially All Their Services for a Publicly Held Corporation

The Proposed Regulations provide that, for purposes of determining whether an employee is one of the five highest compensated employees under section 162(m)(3)(C), an "employee" of a publicly held corporation would include an individual who performs substantially all of their services for the publicly held corporation, even if the individual is treated as an employee of a person other than the publicly held corporation under section 3401(c). Under this rule, amounts paid by the publicly held corporation for the services of such an individual would be treated as "compensation" to the extent deductible by the publicly held corporation. The Proposed Regulations provide that this rule applies regardless of how the amounts are paid or denominated, and regardless of whether the individual is compensated directly or through a third-party (including related, but unaffiliated, organizations or certified professional employer organizations under section 7705).

The Preamble states that this rule is included in the Proposed Regulations because the adoption of the section 3401(c) definition of compensation could permit avoidance of section 162(m) through the use of third-party payors, which the IRS and Treasury Department do not view as a concern under the other definitions of covered employees due to those definitions' inclusion of all individuals acting as executive officers and the application of the executive compensation disclosure rules under the Exchange Act.

Observation: Although this proposed rule would apply, by its terms, to the identification of the five highest compensated employees, the Proposed Regulations explicitly state that "nothing [in this provision] is intended to imply that such amounts paid to a third party for services by a covered employee, however denominated, are not *already* treated as remuneration for those services and thus compensation for purposes of [the existing rules under section 162(m)]." Proposed Regulation § 1.162-33(c)(3)(iv) (emphasis added). This comment suggests that the IRS and Treasury Department believe that the existing final regulations, which apply to other types of covered employees, incorporate such a rule and that the rule applies more broadly than just to the five highest compensated employees. Corporations should review their compensation arrangements to determine whether this proposed rule would affect the allowable deduction under section 162(m).

Effective Dates

The changes to the definition of "compensation" apply to any deduction for compensation that is otherwise deductible but for the limitations of section 162(m) for taxable years beginning after the later of December 31, 2026, or the date of publication of the Proposed Regulations as final regulations in the Federal Register.

The provisions for determining the five highest compensated employees under section 162(m)(3)(C) (as amended by ARPA) apply to taxable years beginning after the later of December 31, 2026, or the date of publication of the Proposed Regulations as final regulations in the Federal Register.

Footnotes

[1] All references here in to "Code" or "section" refer to the Internal Revenue Code of 1986 as amended.
[2] P.L. 117-2.
[3] P.L. 115-97.
[4] Section 13601(b) of P.L. 115-97. Other changes include the elimination of exceptions to the definition of applicable employee remuneration for qualified performance-based compensation and commissions, expansion of the definition of publicly held corporation, and inclusion of a limited transition rule to grandfather certain payments.
[5] Final regulations addressing TCJA amendments were published in the Federal Register on December 30, 2020 (85 FR 86481).

30 Rockefeller Plaza
New York, NY 10112-0015
United States