

Reproduced with permission from Tax Management Compensation Planning Journal, 49 CPJ 04, 04/02/2021.  
Copyright © 2021 by The Bureau of National Affairs, Inc.  
(800-372-1033) <http://www.bna.com>

## **Section 162(m) and the Impact of the American Rescue Plan Act of 2021**

By *Regina Olshan and Jameson Frazier\**  
*Skadden, Arps, Slate, Meagher & Flom LLP*  
*New York, NY and Palo Alto, CA*

Mark your calendars! As part of the American Rescue Plan Act of 2021<sup>1</sup> (ARPA), the scope of §162(m)<sup>2</sup> has been expanded to include five additional individuals as covered employees, within the meaning of §162(m) (Covered Employees), but the changes will not take effect until taxable years beginning after December 31, 2026. The ARPA, signed into law by President Biden on March 11, 2021, is part of the Biden Administration's \$1.9 trillion response to hasten the U.S. recovery from the Covid-19 pandemic. In the form of relief, it provides, among other things, a tax credit for employers who choose to provide paid sick leave and paid family benefits, \$1,400 per-person checks to certain impacted households, grants to small businesses some of which have been impacted by forced closures and/or occupancy restrictions, and billions in funding for Covid-19 vaccines, testing, contact tracing, and other healthcare-related efforts. In an attempt to cover some of the costs associated with the relief efforts provided for in the ARPA, §162(m) has been modified for publicly held corporations to expand the reach of §162(m) and deny additional deductions that would have been available to such corporations.

\* Regina Olshan is the global head of Skadden's Executive Compensation and Benefits Group. Her practice focuses on advising companies, executives and boards on navigating the regulatory complexities of executive compensation and benefits. She speaks and writes frequently on executive compensation issues, co-chairs "Hot Issues in Executive Compensation," an annual executive compensation conference presented by PLI, and is on the Bloomberg Tax & Accounting Compensation Planning Advisory Board.

Jameson Frazier is an associate in Skadden's Palo Alto office. He advises clients on a broad range of executive compensation and employee benefits matters, including in connection with M&A deals for public and private companies. He has experience advising multinational entities on the implementation and design of their equity compensation plans as well as the impact of M&A on their multinational equity programs. He also advises on the securities and tax law compliance issues relative to executive compensation plans and transactions. He has broad experience with executive agreements, cash and equity-based incentive programs, change-in-control and severance plans, golden parachute compliance, and other deferred-compensation issues.

<sup>1</sup> Pub. L. No. 117-2; *see* ARPA §9708.

<sup>2</sup> All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

Section 162(m) generally limits the deductibility of compensation paid by a publicly held corporation to Covered Employees of such publicly held corporation to \$1 million per year. As part of the ARPA, the term Covered Employees has been expanded from, at least, five officers prior to the ARPA to, at least, 10 officers and employees, as noted below. The impact of the ARPA will be to deny deductions for compensation paid to a publicly held corporations top officers and highest-compensated employees.

## **BACKGROUND**

Section 162(m) was added to the I.R.C. as part of the Omnibus Budget Reconciliation Act of 1993,<sup>3</sup> with final regulations adopted in 1995. In 2017, amendments were made to §162(m) as part of the Tax Cuts and Jobs Act (TCJA),<sup>4</sup> including, among other things, amendments to the definitions of "publicly held corporation," "covered employee," and "applicable employee remuneration." The amendments introduced by the TCJA were further clarified via Notice 2018-68 and the proposed regulations issued on

<sup>3</sup> Pub. L. No. 103-66.

<sup>4</sup> Pub. L. No. 115-97.

December 20, 2019,<sup>5</sup> which were finalized with no changes to the Covered Employee definition.<sup>6</sup>

The \$1 million deduction limitation includes all items of compensation, which generally means the aggregate amount paid to the executive for services performed as a Covered Employee that is allowed as a deduction by the corporation for the taxable year. Prior to the ARPA, the TCJA expanded the definition of compensation to include commissions and performance-based compensation, as well as payments made to beneficiaries of Covered Employees, certain payments made by a partnership to Covered Employees, and payments made to a Covered Employee through a non-employee position (e.g., as a director or advisor). In addition, the Joint Explanatory Statement indicates that compensation will be attributed to the Covered Employee even if the compensation is includable in the income of, or paid to, another individual, such as compensation paid to a beneficiary after the Covered Employee's death, or to a former spouse of the Covered Employee pursuant to a domestic relations order.<sup>7</sup> While the ARPA did not add to the expansive scope of what was includable as compensation for the Covered Employee, the widening of the Covered Employee definition has a similar effect of increasing the amount of compensation that will no longer be deductible.

## **COVERED EMPLOYEE**

Prior to the ARPA, Covered Employees only included officers or former officers, including anyone who (i) served as the Principal Executive Officer (PEO) or Principal Financial Officer (PFO) (or in such capacity) at any time during the taxable year, (ii) the next three highest-compensated officers, and (iii) anyone who had ever served as a Covered Employee since January 1, 2017. Limiting the Covered Employees to officers seemed to track the definition of named executive officer (NEO) for purposes of Item 402 of Regulation S-K, thereby not significantly increasing the administrative burden of keeping track of the compensation paid to such individuals who were oftentimes also Covered Employees. For purposes of Item 402 of Regulation S-K, NEOs include (i) anyone serving as PEO or PFO (or in such capacity) during the last completed fiscal year, (ii) the next three highest-compensated officers who were officers at the end of the last completed fiscal year, and (iii) up to two additional individuals for whom disclosure would have been provided but for the fact that the individual was not serving as an executive officer at the end of

the last completed fiscal year. The ARPA increases the burden on publicly held corporations to track the compensation of not only officers but also employees who are not usually considered officers.

The ARPA expands upon the definition of Covered Employee by including the next five highest-compensated employees for taxable years beginning after December 31, 2026. Therefore, in addition to anyone who has served as a PEO or PFO (or in such capacity) since January 1, 2017, and anyone who has served as one of the next three highest-compensated officers since January 1, 2017, the next five most highly compensated employees, whether or not they are officers, will also be included in the definition of Covered Employee. Thus in addition to keeping track of compensation for officers pursuant to §162(m) and related SEC disclosure rules, the publicly held corporation will need to also keep track of the compensation of its highest-compensated employees in any given year. The burden is not as high for the employees as it is for officers, however, due to the fact that employees will not forever be deemed Covered Employees – they will be Covered Employees only for the years that their compensation is within the next five highest amongst the corporation's employee population. In addition to the increased administrative burden, the deduction limitation may have a significant economic impact particularly in industries such as entertainment or financial services and others, where compensation of some non-officer employees often dwarfs the compensation of senior management who constitute the corporation's officers. These changes to Covered Employee due to the ARPA will not apply until more than five years from now, but publicly held corporations should be aware of the impending additional financial and administrative burden of these anticipated changes.

## **IMPACT**

Besides denying the deduction in excess of the \$1 million limitation for the additional employees, the ARPA did not change anything with respect to §162(m) and it is yet to be seen whether it will impact the decisions made by publicly held corporations. When performance-based compensation was added to the definition of compensation, for purposes of §162(m), one might have assumed that publicly held corporations would not rely as heavily as they once did on such form of compensation, but that has proven to not be the case. From practice, there has been no noticeable decrease in the use of performance-based compensation. One might even argue that there has been a greater reliance on performance-based compensation due to other concerns such as aligning compensation with perfor-

<sup>5</sup> REG-122180-18, 84 Fed. Reg. 70,356 (Dec. 20, 2019).

<sup>6</sup> T.D. 9932, 85 Fed. Reg. 86,481 (Dec. 30, 2020).

<sup>7</sup> H.R. Rep. No. 115-466 at 489-90 (2017).

mance due to pay-for-performance expectations of investors. Unfortunately, we will need to wait for guidance from the Treasury combined with the then-

current compensation landscape in 2027, before we have a definitive answer as to the impact of such legislation.