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Proposed Regulations Issued Under Internal Revenue Code § 162(m)

February 12, 2025

Changes effective starting on January 1, 2027

In the last few days preceding President Donald Trump's inauguration, the IRS under the Biden administration proposed regulations to implement amendments to Internal Revenue Code § 162(m) that were enacted in 2021 but will first become effective for taxable years beginning after December 31, 2026. The proposed regulations were published in the Federal Register on January 16, 2025, and any public comments on the proposal are due by March 17, 2025.

In light of the subsequent change in administration (and in the spirit of the regulatory freeze ordered by Trump on his first day in office), it is unclear whether the proposed regulations will progress or be adopted.

Regardless of whether final regulations are finally adopted, however, the changes to 162(m) effected by the 2021 amendments will apply to taxable years beginning after December 31, 2026 (unless those changes are revoked or otherwise modified). Accordingly, companies subject to 162(m) – generally only publicly held corporations and certain of their affiliates – should still understand the effect of those amendments.

Brief history of 162(m) and the 2021 amendments

Section 162(m) was first added to the Internal Revenue Code in 1993 and generally denies publicly held corporations a federal income tax deduction for compensation in excess of $1 million paid to "covered employees" in any year. Until 2017, covered employees for any taxable year included only the corporation's CEO and certain other of its "named executive officers" for the applicable year for proxy reporting purposes, excluding the chief financial officer (CFO).

In 2017, as discussed in this prior Cooley alert, 162(m) was amended by the Tax Cut and Jobs Act in certain respects, including to expand the group of covered employees to include the CFO, to provide that any individual who was a covered employee in any year would remain a covered employee in all future years, and to eliminate an exception from the deduction limitation for certain performance-based compensation.

Then, in 2021, 162(m) was again amended by the American Rescue Plan Act (ARPA) to add as additional covered employees for any taxable year any employee who is among the five highest compensated employees for that taxable year, other than the CEO or CFO or the three highest compensated executive officers for the taxable year (who already are covered employees under the pre-ARPA language). Notably, those additional five employees are covered employees for the particular tax year only, not also for all future taxable years, as is the case for the other, pre-ARPA covered employees.

Practical significance

The proposed regulations go into considerable detail regarding how to identify the additional ARPA covered employees. Again, however, even if the proposed regulations are not finalized, companies subject to 162(m) will still need to identify those additional five individuals on an annual basis as required by the statutory language, and it is not too soon to start thinking about implementing any necessary procedures. Even in just their proposed form, the regulations could offer some guidance on how to structure those procedures.

Any company concerned about loss of a deduction under 162(m) may want to consider – before 2027 – how to structure pay programs for 2027 and later years in a manner that will minimize the loss of a tax deduction by reason of 162(m), with an eye toward who the company anticipates the additional ARPA covered employees will

be for a particular year.

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