The American Rescue Plan Act Expands Covered Employees under Section 162(m)

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On March 11, 2021, President Biden signed into law the **American Rescue Plan Act of 2021** ("ARPA"), the $1.9 trillion stimulus bill adopted by Congress in response to the economic fallout from the COVID-19 pandemic. Among the provisions in ARPA are an extension of enhanced unemployment benefits through September 6, 2021, up to $1,400 in direct payments to certain individuals, emergency paid leave, grants to small businesses and other benefits designed to provide fiscal stimulus to the U.S. economy.

To offset some of the spending provisions included in ARPA, ARPA also includes changes designed to increase revenue. One such change expands the scope of Section 162(m) of the Internal Revenue Code to include the compensation paid to additional employees at publicly traded companies as non-deductible compensation.

Background

Prior to ARPA's enactment, Section 162(m) generally prohibited publicly traded 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 (the "Exchange Act")), which consist of the principal executive officer, the principal financial officer and the three other highest compensated officers of the company for the taxable year. Once an officer was considered a "covered employee" under Section 162(m), the applicable officer would be considered a "covered employee" for all future tax years regardless of whether the individual still met the criteria for being a named executive officer, even after the individual had left the company. Thus, by way of example, if an individual was a named executive officer (and therefore a covered employee) for 2019, the deduction limits imposed by Section 162(m) would continue to apply to such individual for 2020 and 2021 even if the officer was not a "named executive officer" under the Exchange Act rules in subsequent years. This is sometimes referred to as the "once a covered employee, always a covered employee" rule.

On December 18, 2020, the Treasury Department and the Internal Revenue Service ("IRS") finalized regulations expanding the scope of Section 162(m) to cover certain publicly traded partnerships, S Corporations and foreign private issuers, as well as repealing a rule that exempted companies that recently went public, including via an initial public offering (IPO).[1]

Impact of ARPA

ARPA expands the group of individuals considered to be "covered employees" under Section 162(m). For taxable years beginning after December 31, 2026, in addition to the principal executive officer, principal financial officer and the three other highest compensated officers, the scope of "covered

[1] Among the changes was an expansion of the scope of "covered employees." Under the regulations, if an officer was a "covered employee" for a company, the company underwent a corporate transaction such as a spinoff, asset sale or stock sale of a subsidiary and, as part of the corporate transaction, the officer no longer worked for the company, the "covered employee" status applied to the officer following the corporate transaction. Thus, even if the officer was no longer considered a named executive officer for the new entity, the officer would still be considered a "covered employee" and the deductibility of his or her compensation by the new entity would be limited by Section 162(m).

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employees" will be expanded to include the company's next five highest compensated employees in that year, regardless of whether they are officers. This has the potential to expand greatly a company's analysis of its employee compensation.

Under the current Section 162(m) rules, a publicly traded company is required to perform an analysis of the compensation paid to its officers similar to the Exchange Act's disclosure rules. This system permits a company to perform its calculations on a relatively limited group of officers for both Section 162(m) and the Exchange Act disclosures. ARPA will increase this analysis by both doubling the number of individuals covered and expanding the universe of individuals that will be covered under Section 162(m) to include employees who are not considered officers and would not otherwise fall under the purview of the Exchange Act.

At this time, Treasury and the IRS have not offered any guidance on how they may require companies to determine the top five highest compensated employees other than the company's named executive officers. One possibility is that Treasury and the IRS may require such calculations be performed using the same methods that the Exchange Act requires for determining the named executive officers of the company. This would require a robust review of employee compensation practices outside of the company's executive officers. To track non-executive officers and employees in a manner similar to the Exchange Act's requirements could introduce significant administrative burdens to companies. Another possibility is an approach similar to that adopted by the SEC for the pay ratio rule, which allows a company to determine its median employee for reporting of the ratio of CEO compensation to median employee compensation based on a custom compensation measure that is consistently applied to all employees, which may include reasonable estimates. This would reduce the company's administrative burden in determining its five highest compensated employees outside of its named executive officers. Yet another approach might be to require companies to use otherwise deductible compensation expenses for each non-executive officer or employee. This could prove less of a burden than the methods described above, but would generally require tracking of compensation expenses on a per-individual basis.

Unlike the current Section 162(m) rules, this new group of covered employees will not be subject to the "once a covered employee, always a covered employee" rule. This may offer some administrative relief to companies since this will limit the bookkeeping necessary to track into the future "covered employees" outside of the named executive officer group while ensuring that the annual limitation on deductibility will not grow beyond current and former named executive officers and just the additional five highest compensated employees that is determined annually (and not the perpetual inclusion of each non-named executive officer as a "covered employee").[2] This feature should also allow companies to exclude from their determination any employees with deductible compensation expenses of less than $1 million for the year.

Next Steps

There are a number of unanswered questions relating to ARPA's expansion of Section 162(m) and, considering that the amendments to Section 162(m) will not be implemented until the 2027 tax year, Treasury and the IRS will have extensive lead time to assess the changes.

[2] In addition, these non-named executive officer employees will not be subject to recent regulations expanding the scope of Section 162(m) – i.e., the "covered employee" status will not follow these employees following a corporate transaction.

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