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Executive Compensation

Expansion of the Million Dollar Compensation Deduction Limitation on the Horizon for Publicly Held Corporations

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The stimulus package portions of the American Rescue Plan Act of 2021 (the "ARPA"), an approximately $1.9 trillion piece of COVID-19 relief, funding and tax legislation which President Joe Biden signed into law on March 11, 2021, may have received most of the public's attention. However, the ARPA also contains an amendment to Section 162(m) of the Internal Revenue Code that needs to be on the financial

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radar of publicly held corporations. Section 162(m) generally limits the ability of publicly held corporations to deduct compensation amounts in excess of $1 million in any year with respect to certain executives of the corporation (i.e., "covered employees").[1]

The Section 162(m) ARPA amendments are currently set to expand the reach of Section 162(m) to cover a larger number of highly paid individuals working for publicly held corporations effective with tax years beginning on and after January 1, 2027.[2] Such expansion is consistent with other recently enacted laws that also featured provisions broadening the scope of the deductible compensation limitation of Section 162(m).[3] In a previous column we discussed the impact of the Tax Cuts and Jobs Act of 2017 (the "TCJA") on Section 162(m) and provided a summary of the history, purpose and impact of its rules based on the guidance then in effect.[4] After the final regulations under Section 162(m) and certain other changes to the proposed regulations were issued, a subsequent column[5] examined the new guidance in order to identify the differences from and similarities to the prior guidance. Now that ARPA is amending Section 162(m) to capture more executives under the "covered employees" definition, publicly held corporations will need to further examine their pay practices and the tax deductions available. Accordingly, this column will review the new rules provided under the ARPA and provide such employers with proactive planning tips to prepare for the January 1, 2027, effective date.

RULES IN EFFECT PRIOR TO ARPA

The following is a brief summary[6] of Section 162(m) prior to the enactment of ARPA provided solely to set the background and establish context for the most recent ARPA amendment:

The Omnibus Budget Reconciliation Act of 1993 added Section 162(m) to the Internal Revenue Code, with final regulations adopted in 1995.[7] Section 162(m) generally prevents "publicly held corporations" from taking a corporate tax deduction for "applicable employee remuneration" paid to any "covered employee" in excess of $1 million.[8] For taxable years beginning on or before December 31, 2017, the term "covered employees" applied to the individual serving as the CEO as of the last day of the taxable year, in addition to the three most highly compensated officers whose compensation was required to be reported to shareholders pursuant to the U.S. Securities and Exchange Commission's ("SEC") disclosure rules.[9]

Beginning in 2018, the TCJA expanded the definition of "covered employees" to include the firm's principal executive officer ("PEO"), principal financial officer ("PFO") or any individual acting in such

capacity during the taxable year, in addition to its three most highly compensated officers aside from the PEO and PFO.[10] Furthermore, the final rule introduced an "evergreen" feature mandating that "covered employees" included any individual who was a "covered employee" for any taxable year beginning after December 31, 2016.[11] As a result, any individual that was a "covered employee" for a tax year beginning on or after January 1, 2017, would remain a "covered employee" for all future taxable years regardless of changes in their employment status (e.g., "covered employees" who changed their role in the company so they would no longer be a "covered employee" or "covered employees" who terminated employment but are still receiving payments from a nonqualified deferred compensation plan or otherwise would continue to count as "covered employees"). Accordingly, under the TCJA, there could be more than five "covered employees" whose compensation would not be deductible if it exceeds the $1 million dollar threshold

RULES IN EFFECT POST-ARPA

While a plethora of other ARPA provisions may have received greater press coverage (for example, the inclusion of $1,400 stimulus checks to U.S. citizens); the amendments to Section 162(m) are certainly major news for publicly held corporations and their top executives and other highly compensated employees. Under the ARPA, Section 162(m) continues to apply the $1 million compensation deduction limitation to the "core five" executives which will still consist of a publicly held corporation's PEO, PFO and three highest-paid executive officers currently covered by Section 162(m). However, the ARPA also extends this limitation to include an additional five highest-paid employees whether or not they are officers of the corporation.[12] As a result, not only does the new law double the core number of individuals captured by the "covered employee" definition by increasing the potential affected group from five to at least ten (note: this number could increase if circumstances require certain legacy "covered employees" to also be included), but it also extends eligibility beyond the C-suite executives as the deduction limitation's reach is no longer restricted to only executive officers.[13]

CORPORATE CHALLENGES CREATED BY THE EXPANSION OF THE COVERED EMPLOYEE GROUP

Publicly held corporations may now be faced with increased administrative challenges when, effective with tax years beginning on

and after January 1, 2027, they face the prospect of having to monitor not only an increased number of "covered employees," but also highly paid individuals who are not executive officers. It is important to note that these new five non-officer employees will not be subject to the TCJA evergreen rule (i.e., the once a "covered employee," always a "covered employee" rule that will continue to apply to the "core five." Thus, while the "core five" executives will always be "covered employees" as long as they continue to receive compensation from the corporation, this new group of the additional five other highly compensated employees are only "covered employees" for the relevant taxable year and such employees will not be "covered employees" in subsequent years unless they again qualify as one of the five additional employees for such tax year. Since this latter group is likely to change from year to year, additional tracking of employees will be required.[14]

Therefore, under these new rules, publicly held corporations will now have to track the following three groups for purposes of monitoring the deduction limitation:

(1) anyone who served as a PEO or PFO for the taxable year;

(2) the next three highest-compensated officers for the taxable year; and

(3) the next five highest-compensated employees regardless of whether or not they are officers.

Employers will need to determine the "covered employees" in group 1 and 2 for each taxable year as these employees will continue to remain as "covered employees" in all subsequent tax years. "Covered employees" in group 3 will need to be tracked from year to year as such "covered employees" will likely change from year to year.

Since monitoring this expanded group of "covered employees" and communicating these new rules to employees may prove difficult, corporations may wish to engage third party consultants to assist with these tasks. The challenge presented with having to track this new group 3 rests not only with the need to monitor them on an annual basis, but also with the expansion of the "covered employee" group to employees beyond the C-suite. Under the pre-ARPA rules, publicly held corporations already had to identify the five individuals in groups 1 and 2 because they were the "named executive officers" ("NEOs") the corporation was required to report under the Securities Exchange Commission disclosure rules.[15]

Since the new rule will also apply to employees generally (as opposed to officers as determined for purposes of the Securities

Exchange Act of 1934 (the "Exchange Act")), this change will likely result in having to include individuals who do not hold policy-making positions within the corporation but now have to be included by virtue of receiving atypically high compensation in a single year (e.g., signing bonus upon hire, change in control payment, severance amount, large retention or incentive-based compensation awards, etc.). Consequently, certain corporate sectors where talent-based pay fluctuates greatly may be disproportionately impacted by being forced to deal with an ever-changing covered employee group annually. Particularly problematic is that under the current Section 162(m) rules, compensation taken into account in identifying "covered employees" is determined pursuant to the methodology applicable to compensation disclosure rules under the Exchange Act and therefore may include amounts that are at risk but will not necessarily be actually earned.[16]

Many publicly held corporations may already have tally sheets or other methodology in place for tracking compensation paid to their executive officers thereby enabling them to accurately and efficiently track such compensation for both Section 162(m) and Exchange Act disclosure purposes. However, with ARPA generally doubling the annual covered employee group and the new expansion of the group to non-officer employees, these companies will now most likely have to create new tracking programs in order to identify and monitor compensation paid to these newly "covered employees." Finally, foreign private issuers ("FPIs") required to register securities under Section 12 or file reports under Section 15(d) of the Exchange Act are subject to Section 162(m), without regard to whether the compensation payable to their executives must be disclosed under the Exchange Act.[17] Now that ARPA has expanded the covered employee group, FPIs may need to develop a system to determine whether or not any compensatory costs are borne by U.S. taxpayers in the group and if they are, whether they may be affected by these rules.

KEY ISSUES TO BE DETERMINED

Effective Date?

As previously discussed, the text of the ARPA indicates that the new rules will not become effective until tax years beginning on and after January 1, 2027.[18] However, whether or not that effective date remains intact is the topic of some debate. Those who oppose the changes imposed by the law hope that the delayed effective date buys time as much can change in Congress during such a delay. In contrast, it is also apparent that Congress, regardless of any changes in the

composition of its members, is most likely going to need more rather than less revenue offsets given the additional infrastructure and other spending bills that are pending. Since this Section 162(m) amendment is estimated to boost revenue by $7.8 billion over its first five years, it seems an unlikely candidate to be repealed prior to its effective date.

In contrast, the House Ways & Means Committee's recent proposal (released in draft form on September 13, 2021) in the budget reconciliation bill, referred to as the "Build Back Better Bill" would accelerate the effective date of the ARPA changes to Section 162(m) to tax years beginning after December 31, 2021.[19] If this bill passes and the provision makes it into the final legislation as currently drafted, employers would have very little time to prepare for these major modifications to Section 162(m) in the next tax year. Perhaps the most difficult challenge would be presented by the new need to calculate total compensation for non-executive employees for whom such calculations were not previously prepared and, in many cases, tracked in such a manner.

Accordingly, taxpayers may wish to consider consulting with their tax advisers now to determine and mitigate the potential impact should this acceleration of the effective date occur. In certain cases, there might be opportunities to mitigate the effects of the changes by accelerating compensation into 2021 (e.g., paying a bonus in 2021 that normally would be paid in early 2022) or by accelerating the vesting of restricted stock that otherwise would vest in early 2022. However, depending on the nature of any such acceleration, the taxpayer should also consult their legal counsel to ensure that it does not create a Section 409A violation prior to implementing such acceleration.

OTHER PROVISIONS IN THE BUILD BACK BETTER BILL PROPOSAL

In addition to accelerating the effective date of the expanded "covered employee" definition, the Build Back Better Bill proposal also includes the following clarifications/changes to the existing Section 162(m) provisions:

- Modification of the definition of "applicable employee remuneration" (i.e., the term used to describe the types of compensation that count toward the $1 million deductible compensation limit) to expressly include (1) performance-based compensation, (2) commissions, (3) post-termination compensation, (4) beneficiary payments and (5) compensation for services to a publicly held corporation even if not directly paid by such company.[20]

- Expanding the application of the Section 414 aggregation rules[21] to all entities subject to Section 162(m) in order to provide that compensation paid for by different members of a controlled group would be aggregated for purposes of determining whether and to what extent a "covered employee" exceeds the limit on deductible compensation. The proposal also authorizes the IRS to issue regulations implementing the aggregation rule, including regulations to prevent avoidance of the deduction limitation (i.e., classifying individuals as other than an employee or compensating individuals through a pass through or other entity).[22]

Issuance of Additional Guidance Prior to Effective Date?

In the event that the original delayed effective date of the ARPA remains in place (i.e., effective for taxable years beginning on and after January 1, 2027), taxpayers and practitioners may receive additional guidance in the form of Treasury regulations prior to having to implement procedures to accommodate and comply with the new rules. It would be highly beneficial for such guidance to include grandfather provisions for deferred compensation and/or other compensation arrangements already in place prior to the effective date. However, there is no guarantee that such relief will be provided.

Planning Pointers for Preserving Deductions

Since the new rules under the ARPA create the potential for yearly turnover of the next five highest-paid individuals who must be counted as "covered employees", publicly held corporations may be able to preserve their corporate compensation deductions by structuring current and deferred compensation programs to limit payments to potential employees that may be included in such group to ensure that they do not receive compensation in excess of $1 million in any taxable year during which they may be required to be included in the covered employee group. For example, companies may look to limit current compensation during such years and instead defer compensation payments to a later year after the recipient is no longer a "covered employee," such as after they terminate employment. Alternatively, companies may elect to provide additional compensation in the year prior to ARPA becoming effective or the taxable year in which the employee might be subject to these rules, such as by increasing bonus payments, in order to manage which employees are included in the expanded group.

Additional Practical and Business Issues for Consideration

The potential impact of the new ARPA rules creating a significantly increased amount of nondeductible executive compensation may lead corporations to place a significant emphasis on the deductibility of compensation at the expense of continuing to pay incentives and other executive compensation in a manner consistent with their corporate strategic objectives. Companies who do so may face challenges from executives and employees who may think that such discretionary adjustments to payments or determinations regarding ordinary course awards or compensation increases are no longer being determined based on performance or merit, but instead are being solely influenced by the corporation's objective to avoid exceeding the deductibility limitation of Section 162(m). Alternatively, if corporations are not able to create a combination of current and deferred compensation arrangements that allow them to maintain sufficient levels of pay for their top executives and highly-compensated employees while remaining within the deductible limits, the resulting increase in the amount of nondeductible senior employee compensation may lead to an increase in shareholder claims of mismanagement and/or corporate waste.

CONCLUSION

Even if the original January 1, 2027, effective date of the new Section 162(m) rules survives, publicly held corporations should begin reviewing their compensation arrangements and begin deferred tax planning sooner rather than later because the effect of the ARPA could negatively impact their future compensation deductions if sufficient planning is not completed. There is no doubt that deferred compensation programs will serve a key role as corporations seek to continue to provide their key employees with the desired levels of pay without exceeding the deductible limits in the process.

In addition, employers will need to implement new systems to accurately identify and track the expanding group of covered employees who will be subject to the deduction limitation under the new rules. Of course, if the proposed acceleration of the effective date of these new rules under the Build Back Better Bill is passed, it will create an immediate sense of urgency for this planning and systems implementation.

Given the complexity involved with the new rules, the necessary tracking systems that should now be implemented and the need to review existing compensation arrangements as a prerequisite to

determining what, if any, changes should be considered, publicly held corporations should consult their employee benefit consultants and legal advisors in order to prepare for the upcoming transition.

LEGISLATIVE UPDATE

The foregoing column mentions the potential impact that the Build Better Back Act could have on the rules discussed therein, including a proposed acceleration of the effective date of the expansion of the "covered employee" group change from January 1, 2027 to January 1, 2022. As of press time, the Build Better Back Act has been passed through the House of Representatives but still is awaiting Senate approval and then must be signed by President Biden before becoming law. The proposed acceleration of the above-referenced January 1, 2027 effective date did not survive in the final version released from the House; however, the other Section 162(m) changes included in the original version of the Build Better Back Act have been retained in the version that is now being reviewed in the Senate. Such changes, which currently do remain effective as of January 1, 2022 and are summarized in the column, include an aggregation requirement and clarification of the "applicable employee remuneration" definition.

NOTES

1. I.R.C. Section 162(m)(1).

2. American Rescue Plan Act of 2021, Pub. L. No. 117-2, § 9708, 135 Stat. 4, 206 (2021).

3. *See e.g.*, Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, § 13601, 131 Stat. 2054, 2155 (2017).

4. *See* our previous column,"Interim Section 162(m) Guidance including Notice that the Days for Amending Plans with Respect to Delaying Distribution of Non-Deductible Deferred Compensation are Dwindling," *Benefits Law Journal*, Vol. 33, No. 4 Winter 2020.

5. *See* our previous column, "Final Section 162(m) Rule Review: Deducting the Differences and Similarities from the Prior Guidance," *Benefits Law Journal*, Vol. 34, No. 1 Spring 2021.

6. For a comprehensive review of the Section 162(m) rules in effect prior to ARPA, see our two previous columns on this topic referenced above.

7. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, §13211, 107 Stat. 312, 469 (1993).

8. I.R.C. Section 162(m)(1).

9. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, §13211, 107 Stat. 312, 469 (1993).

10. Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, §13601, 131 Stat. 2054, 2155 (2017).

11. *Id.* at § 13601(b).

12. American Rescue Plan Act of 2021, Pub. L. No. 117-2, §9708, 135 Stat. 4, 206 (2021).

13. This number could increase if circumstances require certain legacy "covered employees" to also be included.

14. Implementing guidance may address how this group of covered employees will be determined in taxable years in which the transaction occurs (e.g., whether the new group might need to be greater than five, calculating the groups separately for each company).

15. Regulation S-K, 17 C.F.R. §229.402(a)(3) (2021).

16. *See* I.R.C. § 162(m)(4) (includes any remuneration, including benefits, in any medium other than cash, except as expressly excluded); *see also* 17 C.F.R. §229.402(a)(2) (requiring "all plan and non-plan compensation awarded to, earned by, or paid to the named executive officers").

17. *Id.* at 86483.

18. American Rescue Plan Act of 2021, Pub. L. No. 117-2, §9708, 135 Stat. 4, 206 (2021).

19. Build Back Better Act of 2021, H.R. 5376, 117th Cong. § 138501(b) (2021) (released in draft form on September 13, 2021).

20. *Id.* at §138501(c).

21. *Id.* at § 138501(a) (currently applicable only to "covered health insurance providers" under Section 162(m)).

22. *Id.*

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