

# IRS Proposes New 162(m) Regulations

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On January 14, 2025, the IRS and the Treasury Department released proposed regulations under Section 162(m) of the Internal Revenue Code. The proposed regulations implement statutory amendments to Section 162(m) enacted by the American Rescue Plan Act of 2021, which expand the definition of “covered employee”—the individuals whose compensation in excess of \$1 million is not deductible by publicly held corporations—to include an additional five highest-compensated employees for each taxable year.

Comments on the proposed regulations must be submitted by March 17, 2025. The new provisions would generally apply to taxable years beginning after December 31, 2026 or, if later, the date the final regulations are published in the Federal Register.

## EXPANDED GROUP OF COVERED EMPLOYEES

Currently, the coverage of Section 162(m)(3) generally tracks the SEC public company reporting requirements for “named executive officers”, or NEOs, namely (1) employees serving as principal executive officer (the “CEO”) and principal financial officer (the “CFO”) during the taxable year, (2) the next three most highly compensated executive officers and (3) any individual who was a covered employee under category (1) or (2) in a taxable year after 2016. For taxable years beginning after December 31, 2026, Section 162(m)(3)(C) adds up to five more covered employees each year. The proposed regulations provide guidance on how these next five highest-compensated employees are determined each taxable year.

Unlike the traditional NEO group, these five employees do not need to be executive officers. Instead, the proposed regulations define “employee” using Section 3401(c), which includes a broad range of common-law employees and corporate officers. For this purpose and in order to address potential tax structuring solutions to preserve deductibility, an individual can be treated as an employee of a publicly held corporation even if formally employed by a different entity (including a staffing firm or a related, but non-public, subsidiary), so long as they perform substantially all of their services for

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the public company. Also, this category of covered employee can include employees who are employed for only a portion of the taxable year.

The determination of which employees are the next five highest-compensated also tracks tax, rather than SEC principles, and is based on the amount of compensation that is paid to the employees by any member of an affiliated group that would otherwise be deductible by the corporation for tax purposes. This test captures any remuneration includible in the income of or paid to an employee for services during the tax year, including performance-based compensation (e.g., bonus payments, stock options and RSUs) but would exclude the accounting value of stock grants that is counted under SEC rules. In general, this approach should be welcome news, as employers will need only to track normal W-2 concepts rather than apply SEC principles to non-executive officers.

Under the existing “once covered, always covered” principle for NEOs, any individual who becomes a covered employee by virtue of being an NEO (CEO, CFO or one of the next three most highly paid executive officers) remains a covered employee for all subsequent tax years, even after they are no longer deemed an NEO. But this same “once covered, always covered” rule does not apply to an individual who becomes covered by being one of the five highest-compensated employees for a taxable year. Such an individual is a covered employee only for that taxable year—unless, of course, they later qualify as an NEO in a subsequent year. As a result, a high-earning employee who is never an NEO may move in and out of covered status annually.

A former NEO will always be a covered employee under the existing 162(m) regulations. However, the proposed regulations clarify that a former NEO—meaning an employee who is a covered employee by virtue of previously being an NEO but who is not considered an NEO in the current taxable year—may also count as one of the next five highest-compensated employees for that year. Because a highly compensated former NEO may qualify as a covered employee in two separate categories, there could be fewer additional covered employees in such a year.

### **AFFILIATED GROUPS, MULTIPLE PUBLIC COMPANIES AND FOREIGN ENTITIES**

The proposed regulations confirm that any employee of any member of an affiliated group that includes a public company can be among the public company’s five highest-compensated employees under the proposed regulations—regardless of which specific entity they serve or are formally employed by. This is to prevent a company from circumventing the \$1 million deduction limit by moving highly compensated employees around in an affiliated group.

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If an affiliated group contains more than one public company, each public company in the group has its own covered employees, including the new five highest-compensated employees. However, the group is effectively subdivided for each public company under a framework set forth in the proposed regulations so that compensation from one subgroup is not used to determine the five highest-compensated employees in another subgroup. Compensation paid by different members of the group is aggregated for determining if a single individual falls within the top five for any particular public company. The existing proration rules apply to amounts disallowed as a deduction for the new five covered employees.

An affiliated group can include foreign corporations, and compensation paid by those foreign corporations is taken into account to determine whether an individual is among the five highest-compensated employees—if that compensation would otherwise be deductible in the United States. A controlled foreign corporation (“CFC”) might generate deductible compensation allocations for the U.S. public company (via Subpart F or other rules). The proposed regulations add an explicit provision clarifying that the portion of deductions for compensation paid to employees from a CFC within the affiliated group is included for Section 162(m) purposes. The IRS seeks input in its Proposed Regulation on applying these rules to CFCs, especially if they are not considered part of the affiliated group, indicating that certain issues remain open for discussion in the final regulations.

### KEY TAKEAWAYS AND PRACTICAL STEPS

- **Five More Covered Employees:** The addition of up to five extra covered employees per public entity means more high earners—beyond the traditional NEO group—will face the \$1 million deduction cap beginning in taxable years after December 31, 2026 (or if later, when the final regulations are adopted).
- **Affiliation and Structuring:** Public companies with complex affiliate structures or foreign subsidiaries should evaluate how compensation is allocated and reported, particularly where multiple public companies exist in the same group.
- **Timing of Compensation Deductions:** The proposed regulations do not include special rules with respect to this category of covered employees for compensation that is either not deductible in the current tax year (such as equity awards that are not settled or exercised during the year) or not deductible at all (such as incentive stock options). Under the proposed regulations, a large stock option exercise in a particular tax year could cause an employee who otherwise would not be among the highest earners to become one of the additional top five. Similarly, if compensation

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is deferred to a later tax year, the proposed regulations indicate that it would not factor into the compensation calculation until paid and included in the employee's income—potentially allowing high earners to avoid covered-employee status in a given year by deferring substantial pay. Unless the final regulations adopt special rules for these types of compensation, public companies will face the added complexity of discerning the five highest-compensated employees from those with the *potential* to be among the highest-compensated employees and may need to reevaluate the methods used to track (and predict) when compensation will be includible in employee income for tax purposes.

- **Prepare for 2027:** Although the new rules will not apply until taxable years beginning after December 31, 2026, public companies should begin monitoring potential exposure for employees likely to cross the \$1 million threshold, especially those in multi-year arrangements or with outstanding long-term incentive awards that are expected to vest and settle in 2027 or later.
- **Watch for Final Rules:** The proposed regulations may evolve based on public comments. Interested stakeholders have until March 17, 2025, to submit feedback on the mechanics of identifying the five highest compensated employees and coordinating multiple public companies within an affiliated group.

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Please do not hesitate to contact us with any questions.



**Simone S. Hicks**  
Partner, Washington, D.C.  
+1 202 383 8210  
sshicks@debevoise.com



**Jonathan F. Lewis**  
Partner, New York  
+1 212 909 6916  
jflewis@debevoise.com



**Frank Mitchell**  
Partner, New York  
+1 212 909 6104  
fmitchell@debevoise.com



**J. Michael Snypes, Jr.**  
Partner, New York  
+1 212 909 6319  
jmsnypes@debevoise.com



**Alison Buckley-Serfass**  
Counsel, Washington, D.C.  
+1 202 383 8084  
aebuckleyserfass@debevoise.com



**Sarah A. Burke**  
Counsel, New York  
+1 212 909 6765  
saborke@debevoise.com



**Kathleen M. Emberger**  
Counsel, New York  
+1 212 909 8326  
kmemberger@debevoise.com



**Douglas M. Hirn**  
Counsel, New York  
+1 212 909 6490  
dmhirn@debevoise.com



**Alexandra M. Schoellkopf**  
Law Clerk, New York  
1 212 909 6064  
amschoellkopf@debevoise.com

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