Pearl Meyer

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Expansion of Covered Employees Subject to 162(m) Compensation Deduction Limit



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Our old friend, Section 162(m) is getting another makeover, this time from the latest stimulus package in the American Rescue Plan Act of 2021 (the ARPA). Section 162(m) of the tax code generally prohibits a public company from deducting more than $1 million in compensation paid to a current or former "covered employee" in a taxable year. Under current law, the "covered employees" are the chief executive officer, chief financial officer, and the three other highest compensated officers for the taxable year. An employee who meets this criteria in any taxable year is permanently treated as a covered employee of the company for all subsequent years, regardless of whether the employee continues to the meet the criteria.

Under tax current rules, while non-executive officers (e.g., entertainment personalities and traders) may earn many times more than executives officers, they are not subject to the 162(m) deduction limit. Starting in 2026, that will no longer be the case. The ARPA provides that effective for any taxable year *beginning after December 31, 2026*, the covered employees for a taxable year will also include the company's five highest compensated employees in that year (in addition to the chief executive officer, chief financial officer, and three other highest compensated officers). However, unlike other covered employees, these additional five employees will not become permanently treated as covered employees and will be re-determined each year. This amendment is expected to boost revenue by $7.8 billion over its first five years. As such, the prospect of repealing this provision prior to its effective date seems dubious at best at this juncture given the size of the stimulus package.

Keep in mind, however, the disclosure rules (which require compensation information for "named executive officers" or "NEOs" who are still defined as the CEO, CFO, and three next highest paid executive officers) are different from the new tax rules (which refer to "covered employees" who now include the NEOs plus five new players potentially outside the c-suite).

When the SEC revamped its proxy disclosure rules in 2006, it attempted to implement the so-called "Katie Couric rule," which would have required compensation proxy disclosure not only for NEOs, but also the top three other employees, regardless of whether they were executive officers. That proposal was quickly shot down in the final rules. While the

tax deduction limit will now apply to at least ten current employees (as well as former covered executive officers) in any given year, the reporting requirements in the proxy statement will continue to apply only to NEOs unless the SEC revisits the issue. Thus, at least for disclosure purposes, the “Katie Couric rule” has not been resurrected.

About the Author

Deb advises on executive compensation from a legal and regulatory perspective, including securities disclosure, tax and governance matters, contract negotiation, and reasonableness opinion letters.

About Pearl Meyer

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