

Memorandum

Treasury Proposes Section 162(m) Regulations to Effect Increase in Number of “Covered Employees” Starting in the 2027 Tax Year

January 17, 2025

Overview

On January 14, 2025, the Internal Revenue Service (IRS) and Department of the Treasury released [proposed regulations under Section 162\(m\)](#) of the Internal Revenue Code (Section 162(m)), which limit the ability of public corporations to deduct compensation paid to “covered employees” in excess of \$1 million annually. The proposed regulations implement a statutory expansion of the deductibility cap from a group of specified “executive officers” to up to another five employees each year who are identified as the company’s highest compensated employees (the “Top 5 Employees”). ***This expansion applies for taxable years beginning after December 31, 2026.***

Key Takeaways

- *All common law employees of a public corporation and its affiliated group need to be evaluated for Top 5 Employee status. This includes employees of related but unaffiliated entities and professional employer organizations (PEOs) who provide substantially all of their services to the public corporation and its affiliated group.*
- *The Top 5 Employees will be determined based on their taxable compensation for the applicable year, and not based on total compensation as calculated under the Securities and Exchange Commission’s (SEC) summary compensation table rules.*
- *The Top 5 Employees can include Covered Officers from a prior taxable year, meaning that in some years, the expanded definition may not add five additional covered employees.*

Currently, “covered employees” for a taxable year include a public corporation’s principal executive officer, principal financial officer and three other highest compensated executive officers based on total compensation as calculated under the SEC’s summary compensation table rules (Item 402(c) of Regulation S-K) (together, the “Covered Officers”), as well as any person who has been a Covered Officer in a previous taxable year beginning after December 31, 2016. This group only includes individuals whose compensation is or has been publicly disclosed in annual SEC filings.

Under the American Rescue Plan Act of 2021, for taxable years beginning after December 31, 2026, the definition of “covered employees” was expanded to include the five highest compensated **employees** (not just executive officers) of the public corporation for a taxable year other than the Covered Officers for that same taxable year. This expansion will require public corporations to look to a wider group of employees to determine whose compensation is covered by the Section 162(m) deduction limitation by virtue of being a Top 5 Employee (in addition to continuing to identify the Covered Officers). Unlike the Covered Officers, the Top 5 Employees will only be covered employees subject to Section 162(m) for the taxable year for which they are determined to be a Top 5 Employee (whereas Covered Officers remain subject to Section 162(m) for all subsequent taxable years, regardless of any changes to their officer or employment status). The proposed regulations provide guidance on how to determine the Top 5 Employees.

The comment period for the proposed regulations runs until March 17, 2025.

DEFINITION OF “EMPLOYEE”

The proposed regulations provide that for purposes of determining the Top 5 Employees, the term “employee” includes all common law employees and officers of a public corporation and its affiliated group. An individual who is an employee of a related but unaffiliated entity (such as a partnership or its subsidiaries from which the public corporation receives services) or a PEO needs to be evaluated for Top 5 Employee status if the individual performs substantially all of the individual’s services during the taxable year for the public corporation and its affiliated group. Public corporations will need to consider if additional coordination with unaffiliated employers from which the public corporation obtains service providers is required in order to conduct a complete analysis of the potential Top 5 Employees.

The proposed regulations also clarify that the term “employee” includes officers. Section 162(m) expressly indicates that the Top 5 Employees are in addition to the Covered Officers for the same taxable year, but the Top 5 Employees are not necessarily incremental to Covered Officers from past taxable years. The proposed regulations take the position that a Covered Officer from a past taxable year can also be counted as a Top 5 Employee for later taxable years. As a result, the expansion of the rules may not add five incremental persons every year.

DEFINITION OF “COMPENSATION”

The proposed regulations provide that the compensation used to determine whether an employee is a Top 5 Employee is the total compensation that, absent Section 162(m), would be allowable as a deduction—in effect, it is the employee’s taxable compensation for the applicable year (regardless of whether the services to which such compensation relates were performed during the taxable year) that will be relevant for this determination. The Treasury Department and the IRS considered using total compensation as calculated under the SEC’s summary compensation table rules for this purpose, which likely would have been more burdensome for most impacted corporations.

Although the approach taken in the proposed regulations on the definition of compensation is likely welcome by companies subject to Section 162(m), it may have the effect of producing unexpected results in a given year. In contrasting examples, a particular employee's compensation for this purpose may increase substantially in light of a stock option exercise, while another employee's compensation may decrease substantially due to deferral elections. It may be very difficult to predict which employees will become "covered employees" in any given year.

Moreover, certain types of compensation are not deductible for U.S. federal income tax purposes, such as "incentive stock options" and "profits interests" (including carried interest and certain types of partnership "LTIP" awards commonly used by public REITs). The exclusion of these amounts may yield unexpected results.

AFFILIATED GROUPS

Consistent with the current Section 162(m) regulations, which define the term "publicly held corporation" to include an affiliated group of corporations, the proposed regulations provide that all employees of a public corporation and any other corporation in its affiliated group (as defined under Section 1504 of the Internal Revenue Code, without regard to Section 1504(b)) must be considered in determining the Top 5 Employees.¹ The approach taken in the proposed regulations is intended to stop attempted circumvention of the deduction limitation that could otherwise have been available by moving the employment of highly compensated employees from the public corporation directly to affiliated entities.

An affiliated group can contain more than one publicly held corporation, and in such an instance, each publicly held corporation will have its own Top 5 Employees. Whether an individual is a Top 5 Employee is determined separately for each publicly held corporation in the affiliated group. The proposed regulations provide guidance on how a larger affiliated group will be subdivided into smaller affiliated groups, each aligned to one of the publicly held corporations in the larger affiliated group. Each affiliated group will be required to identify for each taxable year a parent corporation for these purposes.

Consistent with the current Section 162(m) regulations, the proposed regulations provide that an affiliated group includes foreign corporations. Compensation paid by a foreign corporation member of an affiliated group is included in compensation used to determine the Top 5 Employees to the extent the compensation is otherwise allowable as a deduction with respect to U.S. tax obligations.

If an employee of a public corporation is paid compensation by more than one member of an affiliated group, then compensation paid to the employee by each member of the affiliated group (including any distributive share from

¹ Under Section 1504, affiliation is determined through an unbroken chain of corporate stock ownership. A chain of corporate stock ownership is broken by an interposed regarded entity that is not an includable corporation (*i.e.*, an interposed partnership severs the relationship required for affiliation even where the partnership is wholly owned by affiliated corporate partners). For this purpose, a "regarded entity" means an entity that is treated as separate from its owner for federal income tax purposes.

a partnership) is aggregated in determining whether the employee is a Top 5 Employee, excluding compensation taken into account with respect to another publicly held corporation in the affiliated group, if applicable.

The proposed regulations provide a series of examples to illustrate the above summarized principles.

Next Steps

With two years to prepare for this expansion of the Section 162(m) deductibility cap, consider future compensation planning beyond executive officers and how this change might alter expectations. Start coordination efforts across your affiliated group and with unaffiliated service providers and PEOs to track compensation in line with this guidance. It also may be helpful to accelerate upcoming meaningful one-time payments before the end of 2026.

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