

Publications

IRS Issues Proposed Regulations Implementing Changes to Code Section 162(m)

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On January 14, 2025, the Internal Revenue Service (“IRS”) and the Department of Treasury issued [proposed regulations](#) under Internal Revenue Code (“Code”) section 162(m), which limits the deductibility of certain employee remuneration in excess of \$1,000,000 by public companies. These proposed regulations implement changes made to Code section 162(m) in the American Rescue Plan Act of 2021 (the “ARPA”), which added Code section 162(m)(3)(C).

Background

Code section 162(m) generally limits the ability of publicly held corporations to deduct the remuneration of certain “covered employees” in excess of \$1,000,000 from corporate income. Currently, covered employees generally include:

- The principal executive officer (“PEO”) and principal financial officer (“PFO”) of the corporation; and
- The next three highest compensated “executive officers” (other than the PEO or PFO) as defined under the Securities Exchange Act of 1934 (“Exchange Act”) rules.

Employees on this list (the “Top 5 List”) for any taxable year beginning after December 31, 2016 remain covered employees for all subsequent taxable years (often colloquially referred to as the “once a covered employee, always a covered employee” rule).

In 2021, the ARPA amended Code section 162(m)(3) by adding a new subsection (C). Code section 162(m)(3)(C) generally provides that a “covered employee” also includes, for tax years after December 31, 2026, a corporation’s five highest compensated employees other than employees on the Top 5 List (the “Next 5 List”).

Proposed Regulations

The proposed regulations implement Code section 162(m)(3)(C) and notably define key terms and address a number of potential issues associated with determining the Next 5 List. Specifically:

- **Employee** – An “employee” for purposes of Code section 162(m)(3)(C) means an employee as defined in Code section 3401(c). Code section 3401(c) defines an employee to include both common law employees and officers of a corporation. The proposed regulations clarify that the Next 5 List may also include any employee of the publicly held corporation’s affiliates (e.g., non-public subsidiaries), regardless of whether the employee performs services for the publicly held corporation itself. The proposed regulations also provide that the Next 5 List may include an employee of an unaffiliated organization (such as a professional employer organization (“PEO”)) who functions as an employee of the publicly held corporation.

The preamble states that the IRS proposed a broad definition of “employee” to prevent abuse. For example, the IRS noted its concern that a publicly held corporation might otherwise attempt to thwart the intent of Code section 162(m) by employing many of its highest compensated employees at subsidiaries or adopting a holding company structure.

- **Compensation** – For purposes of the Next 5 List, compensation is calculated based on amounts that, but for Code section 162(m), would be allowed as deductions. This calculation is different from how compensation is determined for the Top 5 List, which is based on compensation that is required to be publicly disclosed under the Exchange Act. The preamble clarifies that compensation for purposes of the Next 5 List includes remuneration paid by foreign-affiliated corporations to the extent the compensation is otherwise allowable as a deduction.

The proposed regulations also addressed a number of other key questions implicated by Code section 162(m)(3)(C), most notably as follows:

- **Annual Determination of the Next 5 List** – The proposed regulations clarify that the Next 5 List should be determined annually by taxpayers, and an employee on the Next 5 List in a prior year does not automatically qualify as a covered employee in a future year. Thus, the “once a covered employee, always a covered employee” rule does not apply to employees who are on the Next 5 List but have never been on the corporation’s Top 5 List.
- **Next 5 List and Other Covered Employees Under Code Section 162(m)** – Under the proposed regulations, the Next 5 List may include individuals who are already covered employees by virtue of being on the corporation’s Top 5 List in a prior year. In those instances, there will be fewer covered employees subject to Code section 162(m) limitations in that year.
- **Multiple Affiliated Groups** – The proposed regulations provide that, consistent with the current regulations for affiliated groups that contain multiple publicly held corporations, each publicly held corporation in an affiliated group has its own Next 5 List. The proposed regulations also provide rules for dividing up affiliated groups into smaller groups for purposes of allocating employees onto the applicable Next 5 List.
- **Compensation from Multiple Members of an Affiliated Group** – The proposed regulations provide that, if an employee of a publicly held corporation receives compensation from more than one member of an affiliated group, the compensation generally is aggregated for purposes of determining whether the employee is on the Next 5 List.

As drafted, the proposed regulations apply to compensation that is otherwise deductible for taxable years beginning after the later of (1) December 31, 2026 or (2) the date of final regulations. Comments on the proposed regulations must be received by March 17, 2025.

Notably, the proposed regulations were published in the Federal Register on January 16, 2025. Thus, the proposed regulations do not appear to be affected by President Trump’s [Executive Order](#) to withdraw rules that have not been published in the Federal Register as of January 20, 2025.

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