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Executive Compensation & Employee Benefits Update — January 24, 2025

Today’s Compensation Decisions, Future Lost Deductions: Planning for the Expansion of Section 162(m)’s $1 Million Compensation Deduction Limitation

Recently proposed regulations provide that, for taxable years beginning after December 31, 2026, the definition of “covered employees” will be expanded to include a company’s next five highest compensated employees for each taxable year in addition to those employees that already fall into such definition, regardless of whether they are officers of the company.

Last amended in 2017, Section 162(m) of the Internal Revenue Code generally prohibits publicly held corporations from taking income tax deductions for annual compensation in excess of $1 million paid to the company’s “covered employees.” Currently, “covered employees” include a company’s principal executive officer, principal financial officer, and three other most highly compensated executive officers determined based on total compensation required to be disclosed pursuant to Item 402 of Regulation S-K (thus, typically, the company’s “named executive officers” as disclosed in the company’s Form 10-K or annual proxy statement for the year). If a person is designated as a “covered employee” after December 31, 2016, the person remains a “covered employee” in perpetuity.

On January 14, 2025, the Internal Revenue Service and Treasury Department issued proposed regulations to implement statutory changes to Section 162(m) enacted by the American Rescue Plan Act of 2021. In implementing these changes, the proposed regulations provide that, for taxable years beginning after December 31, 2026, the definition of “covered employees” will be expanded to include the next five highest compensated employees for each taxable year, regardless of whether they are officers of the company. These additional highly compensated employees may change from year to year and will not remain “covered employees” in perpetuity.

- The proposed regulations clarify a few points in determining who qualifies as one of the next five highest compensated employees who make up these additional “covered employees.” Specifically, companies will need to consider all of their common law employees and officers, as well as employees and officers of any member of the company’s affiliated group. Employees for this purpose also include employees of related management entities or professional employer organizations who perform substantially all of their services during the taxable year for the publicly held corporation or members of its affiliated group.
- In ranking employees to determine who is the most highly compensated, companies must look at compensation that would be deductible in that tax year but for the application of Section 162(m). As a result, compensation that may be granted in 2025 or 2026 but that is includible in income and deductible by the company in 2027 will be counted for purposes of determining who is an additional “covered employee” for the 2027 tax year. This may have an immediate impact on companies’ annual compensation planning and how they account for tax for financial statement purposes.
- The five highest compensated employees for a given taxable year may include individuals who were already among the company’s covered employees by virtue of previously being a named executive officer for a prior taxable year.

The proposed regulations include several examples that provide guidance with respect to application of these changes.

In anticipation of the changes to Section 162(m), companies may wish to review their employee population (including employees of their affiliated group) and begin to track compensation to determine how these changes may affect the company’s group of “covered employees” for purposes of Section 162(m). Special attention should be given to particularly large cash or equity awards that may vest or become payable in or after 2027.

The following Gibson Dunn lawyers assisted in preparing this update: Sean Feller, Krista Hanvey, Kate Napalkova, and Alli Balick.

Gibson Dunn’s lawyers are available to assist with any questions you may have regarding these issues. To learn more about these developments, please contact the Gibson Dunn lawyer with whom you usually work, any leader or member of the firm’s Executive Compensation and Employee Benefits practice group, or the authors:

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