

IRS Publishes Proposed Regulations to Expand Denial of Compensation Deduction Under Section 162(m)

Section 162(m) of the U.S. Internal Revenue Code (“Section 162(m)”) generally prohibits a public company from claiming a tax deduction for any compensation in excess of \$1 million paid to any employee covered by Section 162(m). Currently, Section 162(m) covers the public company’s CEO, CFO and three most highly compensated executive officers, subject to certain special rules. As part of the American Rescue Plan Act of 2021 (the “ARPA”), Congress directed the IRS to expand the group of employees covered by Section 162(m). On January 16, 2025, the IRS published proposed regulations (the “Proposed Regulations”) to implement the expansion required by the ARPA.

The key features of the Proposed Regulations are as follows:

- the changes would apply for tax years beginning after December 31, 2026;
- the additional employees covered would be the five highest compensated employees of the company who are not currently covered by Section 162(m);
- these additional employees are not required to be executive officers, potentially capturing highly paid employees who are not part of the company’s c-suite or officer ranks;
- “compensation” for these purposes is compensation that would otherwise be deductible, as opposed to compensation for Summary Compensation Table purposes, which is used to determine other covered employees; and
- the additional five covered employees would be determined each taxable year and, unlike other employees covered by Section 162(m), would not roll forward (*i.e.*, would not automatically continue to be covered employees in future years).

WHAT ARE THE CONSEQUENCES OF BEING A COVERED EMPLOYEE FOR SECTION 162(M)?

Section 162(m) generally prohibits a public company from claiming a tax deduction for any compensation paid to any covered employee in excess of \$1 million in a given taxable year.

There is no direct impact on the covered employee.

HOW IS “EMPLOYEE” DEFINED IN THE PROPOSED REGULATIONS?

The Proposed Regulations define “employee” by reference to Section 3401(c) of the Internal Revenue Code and corresponding regulations, which generally include common law employees and officers of a company. The term employee also includes individuals employed by a third party, *e.g.*, a certified professional employer organization, if they nevertheless function as an employee of the company.

The Proposed Regulations also apply to employees on an affiliated group basis, regardless of whether an individual provides services to the public entity.

WHICH COMPANIES ARE SUBJECT TO SECTION 162(m)?

Section 162(m) generally applies to Exchange Act reporting companies, including foreign private issuers. Newly public companies, including newly spun-off companies, are subject to Section 162(m) starting with the tax year in which they become public.

It should also be noted that Section 162(m) provides for a comprehensive, and complex, set of rules governing affiliated groups that have multiple members that are publicly held corporations, as well as how to allocate employees and compensation among them for purposes of Section 162(m).

NEXT STEPS

Interested parties may submit comments to the IRS regarding the Proposed Regulations before March 17, 2025. Following the comment period, the Treasury Department will review the comments and is expected to adopt final regulations.

Given the expansion under the Proposed Regulations is required by the ARPA, we expect the core of the Proposed Regulations to remain unchanged in any final regulations. We recommend that companies be mindful of the potential new rules, in particular how expansive the Proposed Regulations are in determining the five additional covered employees, and have systems in place to identify this additional group.

The Proposed Regulations can be found [here](#).

NEW YORK

Eric W. Hilfers
+1-212-474-1352
ehilfers@cravath.com

Matthew J. Bobby
+1-212-474-1128
mbobby@cravath.com

Amanda Gold
+1-212-474-1110
agold@cravath.com

Jana I. Hymowitz
+1-212-474-1402
jhymowitz@cravath.com

Jonathan J. Katz
+1-212-474-1538
jkatz@cravath.com

CRAVATH, SWAINE & MOORE LLP

NEW YORK

Two Manhattan West
375 Ninth Avenue
New York, NY 10001
+1-212-474-1000

LONDON

CityPoint
One Ropemaker Street
London EC2Y 9HR
+44-20-7453-1000

WASHINGTON, D.C.

1601 K Street NW
Washington, D.C. 20006-1682
+1-202-869-7700

cravath.com

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