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American Rescue Plan Act of 2021: New Tax Deduction Limits on Public Company Executive Compensation

March 17, 2021

The American Rescue Plan Act of 2021, which Congress passed on March 10, 2021 and President Biden signed into law the next day, expands the corporate tax deduction limitations on public company executive compensation by increasing the number of employees to which the limitation applies, continuing a recent trend of curtailing these types of deductions as a revenue raising offset to tax cut and spending bills.

SECTION 162(m) GENERALLY

Enacted in 1993, Section 162(m) of the Internal Revenue Code of 1986, as amended, limited compensation-related tax deductions for each of a publicly-held corporation's "covered employees" (the CEO, CFO and three other most highly-compensated "executive officers" (as defined for SEC reporting purposes)) to \$1 million per year, unless the compensation met certain criteria to be considered "performance-based", in which case the deduction limit did not apply. Section 162(m) is applicable not only to domestic publicly-held corporations but also to foreign private issuers if U.S. tax deductions for executive compensation are relevant to them.

TAX CUTS AND JOBS ACT OF 2017

The Tax Cuts and Jobs Act of 2017 significantly expanded the scope of Section 162(m)'s original deduction limit by removing the "performance-based" compensation exception, subject to certain grandfathering rules that by now have largely run their course. As a result, beginning in 2018, any compensation paid to a covered employee, whether or not performance-based, generally became subject to the \$1 million per year deduction limit. The Tax Cuts and Jobs Act of 2017 also instituted a rule that if an individual was a covered employee for any year, he or she is considered a covered employee (and, therefore, subject to these deduction limitations) for all future years.

AMERICAN RESCUE PLAN ACT OF 2021

The American Rescue Plan Act of 2021 further expands the deduction limitations of Section 162(m), **effective for tax years beginning after December 31, 2026**, by broadening the group to which the limit applies to include the company's five most highly compensated employees in addition to its current and former CEOs, CFOs and other top three proxy officers, regardless of whether those employees are "executive officers" for SEC purposes. However, individuals who become covered employees due to the recent expansion will not be subject to the rule of "once a covered employee, always a covered employee". Instead, their status as covered employees may change from year to year depending on their compensation for the year.

The statutory language relating to these changes is relatively sparse, and will presumably be supplemented with regulatory guidance before the rule becomes effective to answer certain important questions, such as the manner in which compensation is calculated for this purpose (*e.g.*, confirming whether compensation is calculated under SEC reporting principles or tax reporting principles).

While there may be a tendency to put this new rule out of mind since it will not be effective for several years, this impulse should be resisted because, as noted, these types of executive compensation limitations have become popular on a bipartisan basis to raise tax revenue and, therefore, odds are that this rule will not be repealed prior to implementation. In addition, the latest change will be relevant to tax planning earlier than the 2027 effective date as it may act to disallow deductions for awards (such as equity awards with multi-year vesting periods) or other payments granted prior to 2027 but that are ultimately paid in 2027 or beyond.

We are available to answer any question that you may have regarding these statutory developments.

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