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IRS Issues Proposed Regulations on the Expanded Definition of “Covered Employee” Under Code Section 162(m)

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On January 16, the Internal Revenue Service (IRS) published proposed regulations ([90 FR 4691](#)) under Section 162(m) of the Internal Revenue Code. Section 162(m) generally limits the deductibility of compensation paid in any tax year to covered employees of a publicly held corporation to \$1 million.

The purpose of the proposed regulations is to clarify certain ambiguities created by the Section 162(m) amendments in the American Rescue Plan Act of 2021 (ARPA), which expanded the definition of a “covered employee” for taxable years beginning after December 31, 2026.

Background

Prior to the passage of the ARPA, Code Section 162(m) provided that a “covered employee” included the principal executive officer (PEO), principal financial officer (PFO), and the three highest compensated officers, other than the PEO and PFO, at any time during the taxable year, as determined by the Securities Exchange Act of 1934. For tax years beginning after December 31, 2016, such a covered employee remains a covered employee for future years, even if such individual no longer serves in the covered position or is among the three highest compensated officers (the “once in, always in” concept). The ARPA expanded the definition of “covered employee” to also include, beginning after December 31, 2026, the next five highest compensated employees of the publicly held corporation for the taxable year (other than its PEO, PFO, and three highest compensated officers), but only for the taxable year in which they are part of the next five group.

Proposed Regulations

The proposed regulations clarify that “employee” includes not only the executive officers, but also (i) common law employees of the publicly held corporation and its affiliated group, and (ii) individuals who are employed by a separate employer (such as a related but unaffiliated organization or a certified professional employer organization) but nevertheless function as employees of the publicly held corporation by providing substantially all of their services during the taxable year for the publicly held corporation or its affiliated group. For this purpose, the affiliated group includes foreign corporations. Further, the proposed regulations provide that an individual is considered an employee if such individual is an employee on any day in the year, regardless of whether the employee is employed on the last day of the year.

For purposes of determining whether a common law employee (including an executive officer) of the publicly held

corporation is one of the next five most highly compensated employees, the proposed regulations define “compensation” as compensation that would otherwise be deductible for the taxable year but for Section 162(m). The IRS commented that this approach should be easily administrable because companies currently track compensation to determine their tax liability for the tax year. However, the proposed regulations do not address how to treat compensation that is not deductible at all by the corporation (such as incentive stock options) or compensation that is not deductible by the corporation in the current taxable year.

To address the IRS’s concern that a publicly held corporation may attempt to alter the composition of its next five highest compensated employees by transferring highly compensated employees to a subsidiary or adopting a holding company structure, the proposed regulations confirm that any employee of any member of the affiliated group that includes the publicly held corporation may be among the next five highest compensated employees, regardless of whether the employee is an employee or performs services for the publicly held corporation. The proposed regulations also include specific rules for addressing situations where an affiliated group includes a foreign corporation and where more than one publicly held corporation is a member of the affiliated group.

Practical Takeaways

Companies should keep in mind that an individual can simultaneously qualify as a covered employee by being one of the five most highly compensated employees for the tax year and a covered executive officer from a preceding tax year. Also, the “once in always in” rule that applies to the PEO, PFO, and three highest compensated officers is not applicable to individuals who are covered employees by virtue of being among the next five highest compensated employees. Such individuals will be covered employees only for the current taxable year. Companies should carefully track the basis for including an individual in their covered employee population to ensure they know which covered employees must remain covered or fall out of coverage year-to-year.

Further, the proposed regulations require that a different definition of “compensation” be used when determining whether an employee is one of the three most highly compensated executive officers of the taxpayer (other than the PEO or PFO), which is determined by Regulation S-K Item 402 under the Security and Exchange Commission’s proxy disclosure rules, or one of the next five most highly compensated employees for the tax year, which is determined by an employee’s tax-deductible compensation but for Section 162(m), as discussed above. The applicable definition of “compensation” should therefore be carefully reviewed when making these determinations each year.

Although the new rules will not apply until taxable years beginning after December 31, 2026, publicly held corporations should begin to gather information on their employee population and who may qualify as a “covered employee” as part of the next five group.

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