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# OBBBA Impacts on Executive Compensation: Changes to IRC Sections 162(m) and 4960

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### Introduction

On July 4, 2025, H.R. 1 — the One Big Beautiful Bill Act (the OBBBA) was enacted into law. OBBBA introduces significant amendments to the Internal Revenue Code (IRC), including notable changes to sections 162(m) and 4960.[1] Section 162(m) limits the deductibility of executive compensation for publicly held corporations, and section 4960 imposes excise taxes on excess compensation and excess parachute payments paid by certain tax-exempt organizations. These measures serve to raise tax revenue from executive compensation as a partial offset to tax costs elsewhere in OBBBA. This article summarizes the key statutory changes made to sections 162(m) and 4960 by OBBBA and discusses practical implications for affected organizations.

### OBBBA Changes to Section 162(m)

***Pre-OBBBA Law.*** Section 162(m) limits the federal income tax deduction that a publicly held corporation may claim for compensation paid to any "covered employee" to $1 million per year. Covered employees include the principal executive officer, principal financial officer, and the three other highest compensated executive officers of the publicly held corporation. For years after 2026, covered employees also include the next five highest compensated employees, whether or not executive officers (the "five highest paid employees"). Anyone who was a covered employee for a year beginning after December 31, 2016, remains a covered employee for all future years, even after termination of employment (the "once covered, always covered" rule). However, the once covered, always covered rule does not apply to the five highest paid employees.

The section 162(m) limit applies to all compensation, including salary, bonuses, equity awards, and other taxable remuneration, regardless of whether the compensation is performance-based. IRS regulations require the deduction limit to apply to all compensation paid by the corporation and any members of its "affiliated group" as determined under section 1504 (excluding the provisions of section 1504(b)), and the disallowed deduction is prorated among payors. Although partnerships are not included in the section 1504 affiliated group, the section 162(m) regulations require compensation paid by a partnership to a covered employee be included as compensation subject to the deduction limit, to the extent the publicly held corporation (or other member of its affiliated group) receives an allocable share of the partnership's tax deduction for the compensation.[2]

Congress uses section 162(m) as a tax revenue raiser to offset costs in other legislation and has extended the deduction limit over time. For example, before 2018, the section 162(m) deduction limit did not apply to certain "performance-based compensation," but the Tax Cuts and Jobs Act of 2017 removed this exception starting in

 

2018 (subject to certain grandfather rules). Removing the performance-based compensation exception from section 162(m) meant that publicly held corporations were much more likely to have deductions for executive compensation limited. The changes to section 162(m) as part of the Emergency Economic Stabilization Act of 2008 and Patient Protection and Affordable Care Act in 2010,[3] as well as the addition of the five highest paid employees as covered employees starting in 2027 under the American Rescue Plan Act of 2021,[4] all represent further expansions of the section 162(m) deduction limit. The OBBBA changes to section 162(m) discussed below can be viewed as a continuation of this trend.[5]

***OBBBA Changes*.** For tax years beginning after December 31, 2025, OBBBA requires the section 162(m) deduction limit to apply to a publicly held corporation and all members of that corporation's "controlled group" under sections 414(b), (c), (m), and (o), instead of the "affiliated group" under section 1504 as currently required by the section 162(m) regulations. This change means that publicly held corporations must consider compensation paid to employees by all members of the controlled group, both for identifying the covered employees and for determining the amount of compensation received by those covered employees subject to the section 162(m) deduction limit.

The terms "controlled group" under sections 414(b), (c), (m), and (o) and "affiliated group" under section 1504 are both used to aggregate related entities for various federal tax purposes, but they have distinct definitions, requirements, and applications. As explained below, a "controlled group" is the broader concept of the two.

An "affiliated group" is defined in section 1504(a) as one or more chains of includible corporations connected through stock ownership with a common parent corporation, which is itself an includible corporation. The affiliated group applies primarily to determine the group of corporations that may file consolidated federal income tax returns. Noncorporate entities are not included in the affiliated group.[6]

A "controlled group," by contrast, describes a group of related entities treated as a single employer for various employee benefit plan purposes, such as the rules applicable to tax-qualified retirement plans. The definition picks up not only a controlled group of corporations but also certain trades or businesses (whether or not incorporated) under common control, as well as certain "affiliated service groups." The controlled group rules apply family ownership and other attribution rules that generally do not apply in determining an affiliated group.

The following chart highlights the key differences between affiliated groups and controlled groups:

| **Feature** | **Affiliated Group (IRC §1504)** | **Controlled Group (IRC §414(b), (c), (m), (o))** |
|---|---|---|
| **Primary Purpose** | Consolidated federal income tax returns | Employee benefit plan qualification and compliance |
| **Entities Covered** | Includible corporations (excludes some) | Corporations, partnerships, proprietorships, service organizations |
| **Ownership Test** | 80% direct ownership (vote and value) | 80% ownership (vote or value), includes attribution |
| **Attribution Rules** | Generally not applied | Applied (family, entity, etc.) |
| **Exclusions** | Certain entities (*e.g.*, S corps, REITs)* | Fewer exclusions; broader application |
| **Stock Definition** | Excludes certain preferred stock | Follows Section 1563/attribution rules |
| **Regulatory Authority** | Section 1502 and consolidated return regs | Section 414(o) and related regulations |

 

**  Per the section 162(m) regulations, these exclusions do not apply for purposes of applying the pre-OBBBA section 162(m) limit.*

Section 162(m) as amended by OBBBA includes rules for allocating any lost tax deductions among the controlled group members in proportion to the compensation paid to the covered employee by each controlled group member, similar to rules in the section 162(m) regulations for allocating lost tax deductions across the affiliated group.

***Practical Implications*****.** The primary impact of the changes to section 162(m) will be for publicly held corporations that include partnerships or other noncorporate entities in their controlled group that are not otherwise included in their affiliate group. The difference matters only to the extent those noncorporate entities pay compensation to employees. The impact may especially hit publicly held corporations with operating partnerships, such as so-called “UPREIT” and “Up-C” business structures.

For example, consider an UPREIT structured as a publicly held corporation with an 80% ownership interest in an operating partnership. The operating partnership pays compensation to a covered employee of the publicly held corporation for services rendered by the covered employee to the partnership. Under the pre-OBBBA rules, the publicly held corporation’s 80% distributive share of the partnership’s compensation tax expense related to that compensation would be required to be treated as remuneration that is subject to the section 162(m) deduction limit. With the OBBBA change, however, the partnership will be part of the publicly held corporation’s controlled group, resulting in 100% of that compensation being included for purposes of the deduction limit.

For those companies with a broader controlled group compared to their affiliated group, such as publicly traded UPREITs or other Up-C structures, the OBBBA change will also likely have a significant impact on the determination of the five highest paid employees who are subject to section 162(m) starting in 2027.

Section 162(m) does not present any significant tax planning or mitigation opportunities, especially after the elimination of the performance-based compensation exception in 2018. The human resources, legal, tax, and accounting teams for publicly held corporations will need to coordinate to ensure that the controlled group is properly identified beginning with the 2026 tax year. Additional implementation details may become available if Treasury and the IRS issue updated regulations for the new rules.

**OBBBA Changes to Section 4960**

***Pre-OBBBA Law*****.** Section 4960 imposes an excise tax on certain tax-exempt organizations (referred to as “applicable tax-exempt organizations” or ATEOs)[7] that pay excessive compensation or excess parachute payments to their executives. The tax is designed to loosely mirror the limitations on executive compensation deductions for publicly held corporations under sections 162(m) and 280G but applies to tax-exempt entities and is structured as an excise tax rather than a deduction disallowance.

The excise tax under section 4960 is at the top corporate tax rate (currently 21%) based on either of the following:

- Remuneration paid by the ATEO to any “covered employee” over $1 million in a taxable year, or

- Any “excess parachute payment” paid in connection with an involuntary termination of employment for any covered employee of the ATEO. An excess parachute payment refers to certain payments contingent on the covered employee’s separation from service that exceed the covered employee’s “base amount” (which is the covered employee’s average W-2 taxable wages from the ATEO over the preceding five years, or shorter period of employment if applicable), but only if the aggregate amount of those payments equals or exceeds three times the base amount.

Remuneration for purposes of section 4960 broadly includes any taxable wages under section 3401(a) (excluding designated Roth contributions), and specifically includes amounts required to be included as taxable wages under section 457(f). The rule is generally understood to include base wages (*i.e.*, salary) when actually or constructively received, and other amounts, like benefits under a section 457(f) plan or nongovernmental section 457(b) plan, at the time of vesting (*i.e.*, when any applicable “substantial risk of forfeiture” as defined under section 457(f) lapses).[8] Vested earnings on previously vested amounts are also considered section 4960 remuneration, but may be potentially offset by losses on such vested benefits. Remuneration excludes amounts paid to licensed medical professionals for the performance of medical or veterinary services. Section 4960 also covers compensation paid to covered employees by the ATEO’s related organizations, which are entities that control, are controlled by, or are under common control with the ATEO, as well as certain supported/supporting organizations under section 509.[9]

Importantly, the covered employees applicable under pre-OBBBA section 4960 are limited to the five highest compensated employees of the organization for the taxable year. This is the feature of section 4960 that OBBBA changes, as discussed below. An individual who was a covered employee for any taxable year beginning after December 31, 2016, remains a covered employee for all future years, including after termination of employment, similar to the “once covered, always covered” rule under section 162(m).

***OBBBA Changes*****.** OBBBA makes a simple statutory change to section 4960 by removing the five-employee limit to the number of covered employees. As result, an ATEO will need to consider **any** employee who has been employed by the ATEO and its related organizations after 2016 as a potential covered employee for tax years beginning after 2025. This change impacts application of both potential triggers under section 4960 – *i.e.*, both the $1 million excess compensation and excess parachute payment triggers.

***Practical Implications*****.** For ATEOs with more than five employees receiving over $1 million in section 4960 remuneration, the OBBBA changes will obviously result in greater section 4960 excise taxes. But there are additional, more subtle potential implications to consider.

First, the definition of section 4960 remuneration is complicated. Some amounts are included when paid, others when amounts are vested even though not yet paid. Vested earnings on deferred compensation are included but can be offset by deferred compensation losses. If the ATEO has related organizations that pay compensation, these determinations are made taking into account that related organization compensation and properly allocated among the various entities. Applying these rules has been challenging when the covered employees were limited to the top five paid employees. With a more expanded list of potential covered employees — that is, **all** employees of the ATEO — the tracking and documentation of section 4960 remuneration will become that much more burdensome beginning in 2026.

Next, ATEOs should look closely at the design of their section 457(f) plans or other arrangements that can create large “clumps” of compensation under section 4960, especially when amounts first become vested. For example, a supplemental executive retirement plan for an ATEO that vests benefits upon attainment of a specified retirement age may create a large amount of one-time compensation under section 4960 for a participant upon attainment of that retirement age. This “clumpy” vesting event, together with other compensation, may cause the individual to have section 4960 remuneration that exceeds $1 million. ATEOs may want to consider new designs for their deferred compensation plans that better spread out section 4960 remuneration upon vesting, such as with graded vesting schedules, although any design changes likely can be applied only on a prospective basis.

Finally, ATEOs should take a fresh look at their severance plans and agreements to consider the potential for excise taxes due to excess parachute payments. Even plans or agreements that pay out amounts at less than three times compensation can trigger excess parachute payments due to the peculiar math that applies to those rules (thanks to section 280G). For example, a relatively newly hired employee who also has electively deferred compensation and has not received significant bonuses may have a relatively low “base amount” under those rules. If severance benefits are based on current salary and target annual incentives and include accelerated vesting of any benefits, the total severance will likely exceed the base amount, and if the severance equals or exceeds three times the base amount, the excess parachute payment excise tax will be triggered. Under the OBBBA changes to section 4960, this analysis will need to be considered for every employee who terminates employment with a severance benefit, not just the five highest paid employees.

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[1] For purposes of this article, all section references are to sections of the IRC, unless otherwise noted.

[2] *See* Treas. Reg. §1.162(m)-33(c)(3)(ii).

[3] In 2008 in connection with the global financial crisis, the Emergency Economic Stabilization Act of 2008 (EESA) established the Troubled Assets Relief Program (TARP). EESA added a new section 162(m) deduction limit applicable to financial institutions that received financial assistance under TARP. The deduction limit was set at a lower level ($500,000) with no performance-based compensation exception and continued applicability to compensation earned in a covered year that is deferred and payable in a later year. This rule no longer applies now that the TARP program is over. Then, in 2010 in connection with the Patient Protection and Affordable Care Act (ACA), section 162(m) was amended to add a $500,000 compensation deduction limit applicable to certain covered health insurance providers, structured like the TARP limit, *i.e.*, without a performance-based compensation exception and applicable to compensation earned in a given year even if deferred and payable in a later year. This ACA limit continues to apply.

[4] See our January 2025 Alert, “IRS Issues Proposed Regulations on the Expanded Definition of ‘Covered Employee’ Under Code Section 162(m)” (here).

[5] Per the estimated revenue effects of OBBBA calculated as of July 1, 2025, by the Joint Committee on Taxation (JCX-34-35, available here), the changes to section 162(m) are estimated to increase tax revenues over the next 10 years by $15.7 billion, and the changes to section 4960 are estimated to increase tax revenues over the next 10 years by $3.8 billion.

[6] However, as noted above, the section 162(m) regulations require compensation paid by a partnership to a

covered employee be included as compensation subject to the deduction limit, to the extent the publicly held corporation (or other member of its affiliated group) receives an allocable share of the partnership's tax deduction for the compensation, even though the partnership is not part of the affiliated group.

[7] An ATEO is an organization that is (i) exempt under section 501(a), (ii) a farmers' cooperative under section 521(b)(1), (iii) has income excluded under section 115(1), or (iv) a political organization under section 527(e)(1). *See* section 4960(c).

[8] A Chief Counsel Advice issued in April 2025 (CCA 202515014) clarifies that employee elective deferrals under a section 403(b) plan and employee elective contributions under a section 125 cafeteria plan should not be considered remuneration for purposes of section 4960, even though the statutory text and IRS regulations are otherwise silent on these items.

[9] *See* section 4960(c)(4)(A). The statute may apply when a covered employee receives no compensation from the ATEO but is compensated by a related taxable organization. This issue may impact corporate controlled private foundations where employees of the related taxable organization that funds the foundation are also employees of the foundation but receive no compensation from the foundation. The section 4960 regulations, however, establish a safe harbor that allows certain employees to be disregarded for purposes of the statute. *See* Treas. Reg. §53.4960-1(d)(2)(ii). Generally, an individual is disregarded if the individual performed services as an employee of the ATEO and all related ATEOs for no more than 10% of the total hours the individual worked as an employee of the ATEO and any related organization during the applicable tax year. An individual is automatically treated as having performed services of no more than 10% of the total hours if the employee performed no more than 100 hours of service as an employee of the ATEO and all related ATEOs during the applicable year. The section 4960 regulations also establish a nonexempt funds exemption when a taxable organization related to the ATEO primarily compensates the employee and the employee does not primarily work for the ATEO or any controlled taxable affiliate. *See* Treas. Reg. §53.4960-1(d)(2)(iii).

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