ALERT MEMORANDUM

ARPA to Expand 162(m) Limits on Executive Compensation

March 16, 2021

If you have any questions concerning this memorandum, please reach out to your regular firm contacts in the Executive Compensation and ERISA group.

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On March 11, 2021, President Biden signed into law the American Rescue Plan Act of 2021 (the "ARPA"), the much-debated $1.9 trillion COVID-19 stimulus legislation.[1] The ARPA includes a provision,[2] added by Senate amendment on March 6, 2021, which will further limit the deductibility of amounts deemed to be "excessive employee remuneration" under Section 162(m) of the Internal Revenue Code of 1986, as amended ("Section 162(m)") for tax years starting after December 31, 2026. This change comes on the heels of other recent expansions of Section 162(m).

Section 162(m) generally limits the amount of compensation expense that a public company may deduct each tax year, disallowing deductions for compensation over $1 million with respect to each of the company's "covered employees." Under current law, the covered employees are generally the company's CEO, CFO and its three other most highly compensated officers, along with individuals who have been previously deemed to be covered employees of the company. Under the ARPA, covered employees will expand to include the next five highest compensated employees of the company; however this new group of employees will not retain the perpetual covered employee status and will be determined annually. This provision is projected to generate $7.8 billion in revenue by 2031.[3]

This memorandum discusses the implications of this ARPA provision, particularly in light of other recent changes to Section 162(m).

[1] The ARPA is available at https://www.congress.gov/117/bills/hr1319/BILLS-117hr1319enr.pdf.
[2] *See* American Rescue Plan Act of 2021, H.R. 1319, 117th Cong. § 9708 (2021).
[3] The Joint Committee on Taxation's Estimated Revenue Effects of the ARPA is available at https://www.jct.gov/publications/2021/jcx-14-21/.

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Implications for Publicly Held Corporations

While the ARPA change to Section 162(m) is brief and straightforward on its face, it has the potential to introduce significant complexity for companies subject to the rule. The expansion under the ARPA comes in the wake of several other material amendments made by the 2017 Tax Cuts and Jobs Act (the "TCJA")—including the elimination of the qualified performance-based compensation exception, the expansion of companies subject to the deductibility limit and the expansion of coverage to former officers—and the issuance of final regulations (the "Final Regulations") under Section 162(m) by the IRS on December 18, 2020.[4] Companies are advised to consider the effects of the ARPA well before its implementation in tax year 2027.

— ***Non-Officer Employees.*** As amended by the TCJA, Section 162(m)(3) defines "covered employee" primarily as the CEO or CFO of the company at any time during the taxable year (inclusive of individuals acting in such roles for interim periods) and the three other most highly compensated officers of the company. On its face, the new rule will also apply to employees generally (as opposed to officers as determined for purposes of the Securities Exchange Act of 1934 (the "Exchange Act")). [5] This change may result in inclusion of individuals who have no policy-making role at the company and pick up individuals who receive atypical compensation in a single year, including in a hiring, change in control or termination scenario, or large incentive-based compensation awards. Note that under the Section 162(m) rules, compensation taken into account in identifying covered employees is determined pursuant to the methodology applicable to compensation disclosure rules under the Exchange Act and therefore may include amounts that are at risk and will not necessarily be actually earned. Industries where talent-based pay fluctuates significantly or where non-recurring, significant grants are common may be disproportionately impacted and face high variability in the annual make up of their covered employee group.

— ***Administrative Burden.*** Many public companies have in place tally sheets or other tracking methodology for compensation payable to their executive officers, which allows them to efficiently track both for purposes of Section 162(m) and for purposes of Exchange Act disclosure. Under the ARPA's doubling of the annual covered employee group and the apparent application to non-officer employees, there is a likelihood that companies will need to look beyond existing tracking programs in order to keep tabs on compensation paid to employees located more deeply within the company. In addition, because payments subject to the limitation include amounts paid to covered employees as common law employees or independent contractors, there may be further layers of complexity in monitoring compensation to ensure compliance.

— ***Annual Redetermination of Non-Officer Employees.*** Under Section 162(m) as amended by the TCJA, once an individual qualifies as the CEO, CFO or one of the three other most highly compensated officers of the company or certain "predecessor" corporations, he or she will continue to be treated as a covered employee indefinitely. In contrast, the next mostly highly compensated

[4] The Final Regulations are available at https://www.govinfo.gov/content/pkg/FR-2020-12-30/pdf/2020-28484.pdf. For a summary of key provisions of the Final Regulations, see our alert memorandum "IRS Issues Final Section 162(m) Regulations", available at https://www.clearygottlieb.com/-/media/files/alert-memos-2020/irs-issues-final-section-162m-regulations.pdf. For a discussion of the Proposed Regulations and "covered employees" after merger and acquisition transactions, see our alert memorandum "Who Are Your Section 162(m) 'Covered Employees' After Mergers, Acquisitions and Other Transactions?", available at https://www.clearygottlieb.com/-/media/files/alert-memos-2020/who-are-your-section-162m-covered-employees-after-mergers--pdf.pdf.

[5] Securities Exchange Act of 1934, 15 U.S.C. §78.

employees in the company will apparently be re-determined on an annual basis, and will not necessarily retain the status of covered employee year over year. The text of the ARPA suggests that this is true even with respect to predecessor entities (i.e., a successor or acquiror company need not deem an individual a covered employee solely due to their having been, by reason of the ARPA expansion, a covered employee of the predecessor company). It is possible, however, that implementing guidance will address how this group of covered employees will be determined in taxable years in which the transaction occurs (e.g., whether the new group might need to be greater than five, calculating the groups separately for each company).

— ***Foreign Private Issuers.*** The Final Regulations affirmed that foreign private issuers ("FPIs") required to register securities under Section 12 or file reports under Section 15(d) of the Exchange Act would be subject to Section 162(m), without regard to whether the compensation payable to its executives must be disclosed under the Exchange Act. In addition, Section 162(m) applies within affiliated groups (determined without regard to the rule excluding foreign corporations) and includes provisions on allocations of compensation within the affiliated group. Particularly in light of the broadening of the covered employee group under the ARPA, FPIs are advised to consider whether any compensatory costs are borne by U.S. taxpayers in the group and if so, whether they may be impacted by these rules.

Other Considerations

— ***Exposure to Stakeholder Claims.*** There may be increased scrutiny by stakeholders regarding whether, and in what way, companies are managing the group of covered employees.

Companies may face challenges from employees concerned that discretionary adjustments to payments or determinations regarding ordinary course awards or compensation increases are being influenced by the deductibility limitation of Section 162(m) rather than performance or merit.

On the other hand, companies may face allegations of corporate waste or similar complaints if they are perceived as failing to maximize tax efficiency in compensation decisions. Historically, and particularly in the absence of fraud or doubt as to the disinterest of the board of directors, plaintiffs in derivative suits have had difficulty overcoming the business judgment rule and establishing a claim of corporate waste as a result of a loss of the Section 162(m) deduction.[6] However, a potential doubling in lost tax deductions made possible by the ARPA rule expansion and the increased complexity of monitoring non-officer individuals to whom it applies may give rise to renewed challenges or novel claims.

— ***Disclosure Obligations.*** The ARPA does not include changes to compensation disclosure rules for Exchange Act reporting purposes. Absent future implementing guidance to the contrary, increased disclosure will likely be unnecessary, except to the extent any aggregate impacts are material for purposes of financial statement, risk factor or similar disclosure.

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[6] *See, e.g.*, Freedman v. Adams, 2012 WL 1345638, C.A. No. 4199-VCN (Del. Ch., Dec. 14, 2011).