EXECUTIVE COMPENSATION

# ARPA Expands Covered Executives, Places New Limits on Compensation Deductibility

By Bob Romanchek and Adam Hearn

On March 11, President Joseph R. Biden Jr. signed into law the American Rescue Plan Act of 2021 (ARPA). A late, unannounced, not debated, and somewhat surprising addition to ARPA expands the limitation on the tax deductibility of executive compensation under Section 162(m) of the Internal Revenue Code. In general, the $1 million corporate tax deduction limit is expanding (with a deferred effective date) from five to ten executives.

Section 162(m) became effective in 1994 as a means of addressing growth in executive compensation levels. It generally prohibits publicly traded companies from deducting, for income tax purposes, compensation in excess of $1 million paid per year to a "covered employee" of the company, with an important exclusion for "qualified performance-based compensation." On Aug. 21, 2018, the Tax Cuts and Jobs Act amended Section 162(m) to eliminate the performance-based compensation exclusion and expand the group of employees covered by the provision.

Prior to the enactment of ARPA, "covered employees" included the chief executive officer, the chief financial officer, and the three other highest-compensated officers at a company for a given taxable year. Note that any employee that meets these criteria (and is thereby included in the proxy statement) is permanently treated as a covered employee, even into retirement, regardless of whether that person continues to satisfy the criteria in any subsequent year. The result is a continual loss of a corporate tax deductibility for compensation paid over $1 million to that executive no matter the year of pay.

Under ARPA, the definition of "covered employees" expands to include the company's five highest-compensated employees in a given year in addition to the chief executive officer, the chief financial officer, and the three other highest-compensated officers (i.e., the total number of covered employees increases from five to ten). An important distinction is that these additional five employees will not be permanently treated as covered employees; rather, the determination of the five additional employees will be made annually.

The late modification to ARPA was added by US Senate Democrats to ensure compliance with the exacting requirements of the budget reconciliation process. This process effectively renders certain legislation immune from Senate filibuster so that a simple majority vote in the Senate is sufficient to pass it. Budget reconciliation requirements also resulted in the expanded limitation becoming effective for tax years beginning after Dec. 31, 2026.

Given the delayed effective date of this provision of ARPA, it is too early to assess the full impact on executive pay that compensation committees will need to keep in mind. However, the provision clearly opens the door to higher corporate taxes and reduced income tax deductions for executive pay; thus, boards should consider the possibility that a simple change will accelerate the effective date of this rule with what is expected from new tax reform legislation.

WITH THE PERFORMANCE-BASED EXEMPTION NOW GONE, THE NEW STATUTORY INCREASE IN THE NUMBER OF EXECUTIVES TO BE COVERED BY SECTION 162(M) IS A PURE INCREMENTAL TAX COST.

In past years, much time and effort was expended to attempt to achieve a performance-based exemption to corporate income tax deductibility rules for executive short- and long-term incentive payouts. But with the performance-based exemption now gone, the new statutory increase in the number of executives to be covered by Section 162(m) is a pure incremental tax cost. And since there is no impact on individual executives, this increased tax cost will remain out of sight and out of focus.

While things may change before the effective date, it is important to monitor the newly enacted law to see if the modified version of Section 162(m) survives or if the effective date is accelerated. If the changes are ultimately implemented in 2027, companies and their boards will need to evaluate the costs of their compensation programs for a larger number of executives. D


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