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American Rescue Plan Act Expands Limits on Tax Deductibility of Compensation

▪ By **Margaret Engel** and **Mike Bonner**

On March 11, 2021, President Biden signed the American Rescue Plan Act of 2021 into law. Effective for taxable years beginning after December 31, 2026, the new law greatly expands the current limit on the tax deductibility of compensation paid to executive officers named in the proxy statement to include the compensation paid to an additional five highest paid employees.

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Key Takeaways

- On March 11, 2021, President Biden signed the American Rescue Plan Act of 2021 ("the American Rescue Plan") into law.
- Effective for taxable years beginning after December 31, 2026, the new law greatly expands the current limit on the tax deductibility of compensation paid to executive officers named in the proxy statement to include the compensation paid to an additional five highest paid employees.
- All compensation of these employees that exceeds $1 million per individual will no longer be deductible in each tax year.

On March 11, 2021, President Biden signed the American Rescue Plan into law. The law includes a provision that expands the definition of a "covered employee" under Section 162(m) of the Internal Revenue Code. Section 162(m) limits the amount of compensation expense that a publicly traded corporation can deduct for federal income tax purposes. Under Section 162(m), any compensation paid to a "covered employee" that exceeds $1 million in a given taxable year is not deductible.

Originally, Section 162(m) defined "covered employee" to include the Principal Executive Officer (PEO), Principal Financial Officer (PFO), the three other highest paid executive officers employed on the last day of the taxable year, as well as up to two additional former executive officers who would have been among the highest paid except for their termination of employment. The 2017 Tax Cuts and Jobs Act (TCJA) amended Section 162(m) to, among other changes, expand the definition of "covered employee" to include any person who served as PEO or PFO during the year, including former employees. The TCJA also dictates that once an employee is considered a "covered employee" for one taxable year, they will continue to be treated as a "covered employee" in all future taxable years.

The American Rescue Plan further expands the definition of "covered employee" for taxable years beginning after December 31, 2026 to add the five other highest paid employees in each taxable year. Notably, this includes employees who do not serve as executive officers of the company. The expanded definition only considers these additional five employees to be covered for the taxable year in which they are one of the five highest paid employees and does not consider them to be covered for all future taxable years. Finally, proxy statement disclosure of compensation of these five employees is not required.