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Ms. Carol Weiser
Acting Benefits Tax Counsel
Department of the Treasury
1500 Pennsylvania Ave., NW
Washington, DC 20220

Ms. Rachel Leiser Levy
Associate Chief Counsel (EEE)
Office of Chief Counsel
Internal Revenue Service
1111 Constitution Ave., NW
Washington, DC 20224

Re: Request for Guidance Related to Changes to Section 162(m) made by the American Rescue Plan Act of 2021

The American Institute of CPAs (AICPA) submits the comments below to request that the Department of the Treasury ("Treasury") and Internal Revenue Service (IRS) prioritize the drafting of guidance in relation to changes made to section 162(m)[1] by the American Rescue Plan Act of 2021 (ARPA).[2]

Background

Section 162(m) of the Internal Revenue Code (IRC) places a $1 million limitation on the amount of compensation related to a covered employee that a publicly held corporation can deduct in a taxable year.

Prior to the passage of the Tax Cuts and Jobs Act[3] (TCJA), under section 162(m) and Notice 2007-49 – Covered Employees Under Section 162(m)(3), the term "covered employee" included the principal executive officer (PEO) as of the last day of the taxable year as well as the three highest paid officers excluding the PEO and principal financial officer (PFO) on the last day of the taxable year. The compensation of the PFO was not subject to the section 162(m) limitation.

Under section 162(m) as amended by the TCJA, the definition of a "covered employee" was broadened to include the PEO and PFO at any time during the year (not just the last day of the year), and the three other most highly compensated officers, for a minimum of five covered employees. The TCJA also mandated that individuals who are covered employees of the employer or any predecessor employer in any tax year beginning after December 31, 2016, are covered employees in all future years, including in retirement and after death (collectively, the "Current Law Covered Employees").

The ARPA added a new subsection to section 162(m), section 162(m)(3)(C), which will further limit the deductibility of certain employee remuneration by expanding the definition of a "covered

[1] Unless otherwise indicated, hereinafter, all section references are to the Internal Revenue Code of 1986, as amended, or to the Treasury Regulations promulgated thereunder.
[2] Pub. L. No. 117-2.
[3] Pub. L. No. 115-97.

1455 Pennsylvania Ave. NW, Washington, DC 20004-1081
T: +1 202.737.6600 F: +1 202.638.4512
aicpaglobal.com | cimaglobal.com | aicpa.org | cgma.org

employee" effective for taxable years beginning after December 31, 2026. Beginning in 2027 for calendar year taxpayers, a public company's covered employees will include the Current Law Covered Employees and the company's 5 highest paid employees other than the Current Law Covered Employees (the "Additional 5"). The employees included in the Additional 5 are subject to change every year, and they do not remain covered employees in future years unless they meet the criteria each year or become a Current Law Covered Employee.

While a public company's annual deduction for compensation paid to the Additional 5 will not be limited until 2027 for tax purposes, its financial statements must reflect the limitation prior to 2027. Consider the following example:

> *Example*
>
> Individual A is employed by a public company. The public company accrues deferred compensation in 2025 for Individual A, which vests over a 3-year period and will be paid in 2030. The public company must account for the expense for each year on its financial statements, beginning in 2025 and must reflect whether the amount will be tax deductible to properly consider deferred taxes.

Recommendation

The AICPA recommends that Treasury and the IRS issue final regulations as soon as possible, but no later than January 2025, stating how an employer should determine the Additional 5, for purposes of the section 162(m) limitation.

Analysis

While public companies are not required to take into consideration the Additional 5 for tax purposes until 2027, the issuance of final regulations no later than 2025 will provide sufficient lead time for companies to comply with the changes made to section 162(m) by the ARPA to accommodate the following:

- The determination of which employees to include in the Additional 5:
    - Under the TCJA rules, once a Current Law Covered Employee is considered a covered employee of the employer or any predecessor employer, they remain a covered employee in all future years. However, an individual who is an Additional 5 covered employee in one year is not automatically a covered employee in any succeeding year.

      It is unclear if an employee would be considered an Additional 5 covered employee or a covered employee by reason of the "once a covered always covered" rule in year 3 of the following fact pattern: Employee A is an officer

of a public company who is a covered employee in year 1. Employee A is not an officer in year 3 but qualifies as one of the Additional 5 in year 3.

- Whether the Additional 5 will include foreign employees.

- How to calculate the annual compensation for purposes of identifying the Additional 5 including, if applicable, how to calculate the annual compensation for foreign employees not paid in U.S. dollars.

- Application of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 740, which governs how companies recognize the effects of income taxes on their financial statements, under Generally Accepted Accounting Principles (GAAP), to the Additional 5.

  For example, a company must understand how to calculate income tax expense related to the Additional 5. When recording a deferred tax asset (DTA) related to compensation expense, a public company is required to estimate its ability to deduct the compensation expense in a future year, which includes accounting for the $1M deduction limitation under section 162(m).

  For example, in 2025, a public company may record a book expense for restricted stock granted in 2025 that will vest and become deductible for tax purposes in 2027. For financial statement purposes, to determine if a DTA should be recorded in 2025 for the book expense, the company must estimate its ability to deduct the expense for tax purposes, in 2027. If it is estimated that section 162(m) would limit the company's tax deduction for compensation in 2027, the company should not record a DTA for this restricted stock expense in its 2025 financial statements. However, if it is estimated that section 162(m) would not limit the company's tax deduction for compensation in 2027, the company would record a DTA for this restricted stock expense in its 2025 financial statements.

- Since the Additional 5 will include non-officer employees and must be determined on an annual basis, a company's current method of tracking compensation paid to executive officers for purposes of the section 162(m) limitation will not be adequate to track the total compensation of "regular" employees considered the Additional 5.

  For example, since it is not necessary for the Additional 5 to be officers of the company, a "regular" employee with an irregular compensation package in one year (due to hiring, termination, etc.) may be one of the Additional 5 in that year only. This type of compensation anomaly will be difficult for an employer to capture and track without pre-determined protocols in place. To ensure compliance with the new rules, companies will require lead time to develop and implement the new tracking protocols.

The changes to section 162(m) made by the ARPA, in addition to the numerous changes made by the TCJA, may introduce significant complexity for public companies subject to the section 162(m) limitation. Therefore, companies must consider the effects of the changes to section 162(m) by the ARPA in advance of the 2027 implementation date. Obtaining guidance as soon as possible, but no later than 2025 is imperative as a first step for companies to comply with the new rules.

The AICPA plans to submit additional comments regarding the determination of the Additional 5.

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We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. If you have any questions, please feel free to contact Tom Pevarnik, Chair, AICPA Employee Benefits Taxation Technical Resource Panel, at (202) 879-5314, or tpevarnik@deloitte.com; Kristin Esposito, AICPA Director – Tax Policy & Advocacy, at (202) 434-9241, or kristin.esposito@aicpa-cima.com; or me, at (601) 326-7119, or JanLewis@HaddoxReid.com.

Sincerely,

Jan Lewis, CPA
Chair, AICPA Tax Executive Committee

cc: The Honorable Lily Batchelder, Assistant Secretary for Tax Policy, Department of the Treasury
The Honorable Charles P. Rettig, Commissioner, Internal Revenue Service
Mr. William Paul, Principal Deputy Chief Counsel (Technical) and Deputy Chief Counsel, Internal Revenue Service
Ms. Helen Morrison, Deputy, Benefits Tax Counsel, Department of the Treasury
Mr. Andrew Holubeck, Attorney-Advisor, Office of Tax Policy, Department of the Treasury
Mr. Ilya Enkishev, Attorney, IRS Office of Associate Chief Counsel (EEE), Internal Revenue Service
Ms. Lynne Camillo, Acting Deputy Associate Chief Counsel (EEE), Internal Revenue Service
Ms. Laura Warshawsky, Deputy Associate Chief Counsel, Employee Benefits, Internal Revenue Service