

# TaxNewsFlash

United States

No. 2025-048  
January 21, 2025

## KPMG report: Proposed regulations on additional five highest compensated employees subject to section 162(m)

Section 162(m) limits the compensation deduction for a tax year for a public corporation to \$1,000,000 for each of its covered employees. Historically, this loss of deduction has applied to compensation for the CEO and three highest paid executive officers, who are referred to as covered employees. The Tax Cuts and Jobs Act (TCJA) expanded the covered employee definition to pull in the CFO and further extended the scope so that once an individual was a covered employee the individual would remain a covered employee for all future taxable years of the public corporation so that for a taxable year the public corporation could have more than five covered employees. For tax years beginning after December 31, 2026, the American Rescue Plan Act of 2021 (ARPA) again expanded the definition of covered employee for purposes of section 162(m) to apply to an additional group of five highest compensated employees who are not the CEO, CFO or one of the three highest paid executive officers of the public corporation for that year. The U.S. Treasury Department and IRS issued proposed regulations providing guidance on how to determine these additional five employees subject to section 162(m). Read [TaxNewsFlash](#)

### Proposed regulations

#### *Employee and compensation*

Under section 162(m)(3)(C), the additional five employees are not limited to officers but can be any employee of the public corporation (and see discussion below of definition of public corporation to include the affiliated group as determined for purposes of section 162(m)). For this purpose, the proposed regulations define the term “employee” to include an employee under section 3401(c), meaning generally a common law employee. These additional five employees also are not subject to covered employee status in future years applicable to the CEO, CFO and three highest compensated officers under section 162(m)(3)(D). Rather, the additional five highest compensated employees will be determined each taxable year and status in one year will not affect status in a subsequent year.

Notably, the proposed regulations confirm that the only employees excluded from being one of the additional 5 employees are those listed under section 162(m)(3)(A) and (B)—the CEO, the CFO and the three highest compensated officers during that year. This means that existing covered employees under section 162(m)(3)(D), meaning employees who are covered employees only because they were the CEO, the CFO or

a three highest compensated officer in a previous year but are not in the current year, may also be an additional five highest compensated employee. For example, an officer who is not the CEO or CFO but is the third highest compensated officer for the 2026 year will be a covered employee for the 2026 year. Even if the officer is the fourth highest non-CEO, non-CFO officer for 2027, the individual will continue to be a covered employee under the permanent covered employee rule for officers under section 162(m)(3)(D). The proposed regulations confirm that the same individual may also be one of the highest compensated employees for 2027 under section 162(m)(3)(C), meaning the covered employee list for 2027 may not increase by five individuals.

Under the proposed regulations, compensation is determined based on the amount that would be deductible, but for section 162(m), as opposed to compensation as determined under the SEC compensation disclosure rules.

#### *Impact of affiliated group rules*

Under the current regulations, a publicly held corporation includes not only the corporation the shares or debt of which is publicly traded, but all members of the affiliated group of corporations including that corporation (as determined under section 1504 but including foreign corporations). Due to concern that a highly compensated employee may be employed at a nonpublic subsidiary corporation, or moved to a nonpublic subsidiary corporation in an attempt to avoid the impact of these expanded rules, the proposed regulations propose that any employee of any corporation within that affiliated group may be one of the five highest compensated employees of the publicly held corporation, even if the employee provides no services to the actual corporation the shares or debt of which is publicly traded. Consistent with the previous regulations, the proposed regulations further address affiliated groups that contain more than one publicly held corporation (for example, the stock of a parent corporation is publicly traded but the debt of a subsidiary corporation is publicly traded), proposing that each publicly held corporation will have its own additional five highest compensated employees. For purposes of determining the five highest compensated employees, compensation paid by all members of the affiliated group is aggregated.

As noted, a section 162(m) affiliated group may include one or more foreign corporations. The proposed regulations provide that compensation paid by a foreign corporation would be considered employee compensation for these 162(m) purposes only if it is otherwise allowable as a deduction in the United States. If an employee is employed by a foreign corporation and compensation is not deductible in the United States (for example, because the foreign corporation does not conduct a trade or business in the United States), then the employee would not be one of the additional five highly compensated employees. As currently proposed, this may mean for certain organizations the vast majority of the highest compensated employees of which work in foreign jurisdictions, the organization will still have to identify its five highest compensated employees who work in the United States or whose compensation is otherwise deductible in the United States (regardless of how lowly ranked by compensation such an individual is as an employee of the public corporation).

The preamble to the proposed regulations notes that certain foreign corporations owned by U.S. corporations—controlled foreign corporations (CFCs)—may have compensation paid by the foreign entity that becomes deductible in the United States through the rules governing CFCs. The proposed regulations would add a rule specifically including this type of compensation in the definition of compensation, but also request comments on any further guidance that may be needed.

#### *Third-party payors of compensation*

The preamble to the proposed regulations raises concerns about third-party payors of compensation who may be treated as “employers” for purposes of the Code, such as payments from a related organization that is not within the affiliated group of the public corporation or a certified professional employer organization (CPEO). To address this situation, the proposed regulations provide that an employee includes who is an employee of a CPEO or other entity if that individual during the year provides “substantially all” of his or her personal services to the corporation. This appears to address at least in part structures similar to affiliated services groups under section 414(m) that would move the individual to an entity outside of the affiliated group of corporations to preserve the deduction.

### *Applicability Date and Comments*

The proposed regulations are proposed to apply for tax years beginning after the later of December 31, 2026, or the date of publication of the final regulations. Comments are due 60 days after publication of the proposed regulations. Because the proposed regulations apply an expansive interpretation of the language of section 162(m)(3)(C) that is arguably beyond its plain meaning as discussed in the preamble, tax professionals anticipate significant commentary on the scope of the rules proposed.

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