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Accounting for Income Taxes Considerations of the Newly Expanded Section 162(m) Excess Compensation Limitation

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The American Rescue Plan Act of 2021 ("ARPA")[1] was signed by President Biden on March 11, 2021, and included changes to section 162(m) [2] that expanded the definition of covered employees and modified the excess compensation deduction disallowance. This article summarizes some of the accounting for income taxes considerations companies should think about when evaluating the impact of the ARPA.

Background

Prior to enactment of the ARPA, section 162(m) precluded a publicly held corporation from taking a deduction for compensation in excess of $1 million with respect to its covered employees. Under existing rules, covered employees included (1) any individual serving as the CEO or CFO during the year, (2) the next three highest compensated officers of the corporation, and (3) any individual who was a covered employee in any tax year beginning after December 31, 2016. Additionally, once an employee was considered a covered employee, the employee remained a covered employee for all future years, including for years during which the employee was no longer employed by the corporation.

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1 Pub. L. No. 117-2.

2 Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

The ARPA expands the definition of a covered employee under section 162(m) to include the five highest compensated employees other than those employees already treated as covered employees. However, this additional group of covered employees are not permanently considered covered employees. The expanded definition of covered employees is effective for tax years beginning after December 31, 2026.

Accounting for Income Taxes Considerations

The change to section 162(m) does not affect a company's current income taxes until periods beginning after December 31, 2026. However, it may affect the measurement of deferred taxes for compensation related temporary differences to the extent the compensation is expected to be reported in tax years beginning after the effective date. In that case, a company should consider the disallowed compensation deduction and reduce the related deferred tax asset to reflect the amount of income tax benefit that it expects to realize in the future (in other words, the tax effect of the amount that is anticipated to be deductible in future periods) for covered employee compensation, taking into account the section 162(m) limitation.

Covered employees may have compensation arrangements that include both share-based compensation and other compensation (including, but not limited to, salary, bonus, and deferred compensation) and the total may be expected to be limited under section 162(m). US GAAP does not describe how a company should allocate the deductible and nondeductible compensation cost for financial reporting purposes when compensation is subject to the section 162(m) limitation. The two most common methods used in practice are the pro rata method and the stock compensation last method.[3]

Pro Rata Method

The estimated income tax benefit for deductible compensation is allocated between share-based compensation and other compensation on a pro rata basis. Deferred taxes are recognized only for compensation up to the amount of the section 162(m) limitation.

Stock Compensation Last Method

The estimated income tax benefit related to other compensation is considered first. Deferred taxes are recognized only for compensation up to the amount of the section 162(m) limitation. If the other compensation is estimated to be equal to or greater than the limitation, no deferred taxes are recognized for the excess of the other compensation or the share-based compensation.

Application of Methods

Many entities may have already adopted a policy to either apply the pro rata method or the stock compensation last method; we would expect those entities to continue to apply their existing methodology.

[3] See paragraph 8.036 of the KPMG *Accounting for Income Taxes* handbook.

Regardless of the methodology applied, the analysis of the deductible compensation related to share-based payment awards should be based on the cumulative amount of compensation costs, which is based on the grant date fair value of the award and does not consider any changes in the fair value of the award that will affect the amount that is ultimately deductible. Upon exercise or vesting of an award, any difference between the estimated amount of deductible compensation for the share-based award and the amount deductible is recorded discretely in income tax expense (benefit). Further, similar to other income taxes related estimates, an entity should continuously reassess its facts and circumstances, and adjust as necessary, to reflect changes to the amount of estimated compensation related temporary differences and deferred taxes.

Example

ABC Corp's Employee A is the fourth highest paid employee after the CEO and CFO and Employee A is expected to stay as one of the highest paid employees of ABC. Employee A's salary is $1 million and is expected to continue at that level in the future. On January 1, 2022, ABC grants Employee A 100,000 shares of non-vested stock with a grant-date fair value of $5 per share. All 100,000 shares vest and all restrictions lapse on December 31, 2027. Since it is management's expectation, based upon currently enacted law, that Employee A will be a covered employee following the effective date included within the ARPA, any compensation related temporary differences that are expected to reverse in years beginning after December 31, 2026, are assessed to determine if section 162(m) would limit the amount of deductible compensation.

Pro Rata Method

Under this approach, ABC Corp would estimate the anticipated total taxable compensation (based on cash compensation and the grant date fair value of the share-based payment award) for Employee A that would be subject to the section 162(m) limitation in the year that the share-based payment award results in a tax deduction. ABC expects that in 2027, when the shares vest, Employee A will have $500,000 (100,000 shares of stock at the $5 grant date fair value) in compensation cost for the stock award to be taxable in addition to $1 million of cash compensation. Additionally, the company expects employee A will be subject to the 162(m) limitation in 2027 as a result of the expanded covered employee definition as enacted under the ARPA. Based on this estimate, the company expects that only 66.7 percent of employee A's compensation will be deductible for U.S. federal income tax purposes after the section 162(m) limitation ($1 million of deductible compensation over total compensation of $1.5 million). Consequently, over the vesting period, a deferred tax asset of $70,000 ($500,000 at a 66.7 percent estimated deductible portion times the 21.0 percent tax rate) will be recognized on the share-based payment compensation cost. The amount of the compensation expense related to Employee A's share-based payment award that is not expected to result in a future deduction is reflected as nondeductible compensation within ABC Corp's rate reconciliation in the period in which the financial reporting compensation cost is expensed.

Stock Compensation Last Method

Similar to the approach above, ABC Corp would estimate Employee A's $1.5 million of total taxable compensation subject to the section 162(m) limitation in the year that the share-based payment would result in a tax deduction. Under this methodology, the other compensation is considered to be deductible first. As the $1 million salary is equal to the limitation under section 162(m), no deferred taxes are recognized for the share-based compensation as no portion of the award is expected to be deductible.

In the scenario described above, both the pro rata and stock compensation last methods result in a reduced temporary difference and a related reduced deferred tax asset; however, ultimately only $1 million of compensation for Employee A is permitted to be taken in years beginning after December 31, 2026, due to the employee becoming a covered employee at that time.

Other Considerations

Many companies may have limited deductible temporary differences that exist today, but for which they expect the ultimate deduction to be affected by the expanded definition of a covered employee included in the ARPA. Stock options and deferred compensation are two common arrangements in which deferred tax assets may exist today, but for which a deduction may not be expected until after 2026.

To the extent an entity has deductible temporary differences that exist and are affected by the expanded definition of a covered employee, the entity should remeasure the deferred tax asset and recognize a discrete adjustment in the interim period that includes the March 11, 2021 enactment date. We believe a company can measure the discrete adjustment either using the enactment date approach, in which the amount of the temporary difference is estimated as of March 11, 2021, or by using a beginning-of-year approach, in which the discrete adjustment is based on deferred tax amounts as of the beginning of the year, consistent with the entity's existing policies on recognizing changes in tax laws and rates during an interim period.[4] To the extent the entity then has a smaller tax benefit related compensation costs for the remainder of the year after enactment of the ARPA, this reduced tax benefit would be part of the estimated annual effective tax rate.

Conclusion

When evaluating the impact of the ARPA, entities should carefully consider the accounting for income taxes consequences of the expanded definition of covered employees in section 162(m) and determine whether any adjustment to its existing deferred taxes, even prior to the effective date of the legislation, are required as a result of enactment.

4 See paragraph 5.017a of the KPMG *Accounting for Income Taxes* handbook.

