Snapshot

June 3, 2025
Snapshot 2025-07

Accounting implications of IRC §162(m) limitations

Section 162(m) of the Internal Revenue Code limits the amount of compensation exceeding $1 million paid to certain employees that is deductible when determining taxable income for federal income tax purposes. The amount of compensation subject to this federal limitation is recognized as an expense for financial reporting purposes, but does not have a future tax consequence, resulting in a permanent difference between income reported for accounting purposes and taxable income. Determining whether amounts of compensation recognized for financial reporting purposes in the current period may be subject to the Section 162(m) limitation in future taxable periods may be challenging, but it is necessary to determine whether such amounts give rise to temporary or permanent differences under ASC 740, *Income Taxes*, and how these amounts may impact an entity's effective tax rate.

Background

In December 2017, the Tax Cuts and Jobs Act (TCJA) was signed into law and expanded the scope of Section 162(m) so that a "public entity" may not deduct compensation earned by a "covered employee" in excess of $1 million from taxable income, regardless of the form of compensation.

A "public entity" under Section 162(m) includes not only entities whose securities are registered with the SEC, but also foreign corporations publicly traded through American depositary receipts (ADRs) as well as certain large private corporations and S corporations. Entities might need to consult with qualified tax experts to determine whether they qualify as a public entity under Section 162(m).

Under Section 162(m) as amended by the TCJA, a "covered employee" is an individual who either (1) served as the entity's CEO or CFO at any point during the taxable year, or (2) is one of the entity's three most highly compensated officers during the taxable year other than the CEO and CFO (referred to herein as "covered executive employees"). Once an individual is a covered executive employee, they remain a covered executive employee whose compensation is subject to the Section 162(m) limitation—even after termination of their employment or death.

In March 2021, the American Rescue Plan Act (ARPA) expanded the scope of employees covered under the Section 162(m) limitation to include an entity's five highest compensated employees during the taxable year who are not already considered covered executive employees with compensation over $1 million, regardless of form (referred to herein as "ARPA 5 employees").

This expansion of Section 162(m) is effective for tax years beginning after December 31, 2026.

Accounting implications

Section 162(m) triggers several accounting issues under ASC 740, including whether portions of employee compensation arrangements that give rise to timing differences between financial accounting and tax recognition result in temporary or permanent differences, and how the Section 162(m) limitations impact an entity's effective tax rate.

Temporary vs. permanent differences

The central accounting challenge posed by the Section 162(m) limitations is determining whether any of an employee's compensation in the current period will give rise to a temporary or permanent difference under ASC 740.

Under ASC 740, a portion of employee compensation recognized in the current reporting period for financial statement purposes that will never be deductible for tax purposes in a future period does not result in the recognition of a deferred tax asset and is referred to as a "permanent difference." If an entity determines that an amount previously considered not deductible would be deductible in future periods based on changes in facts and circumstances, it would recognize a deferred tax asset in the period when its conclusion changes.

Evaluating compensation paid to covered executive employees

Employee compensation arrangements with a covered executive employee under Section 162(m) may result in a timing difference between when the compensation is recognized for financial accounting and for tax purposes. When such a timing difference exists, an entity must determine whether the covered executive employee's compensation will be subject to the Section 162(m) limitation in the tax year when the compensation will be deductible for tax purposes. This assessment must be made on an employee-by-employee basis and must be continually reassessed, as amounts initially determined to be temporary (or permanent) differences could become permanent (or temporary) as facts change.

For instance, if a portion of a covered executive employee's compensation recognized in the current year for financial reporting purposes will not be deductible for tax purposes until a future year, the entity must determine in the current financial reporting period whether it expects the covered executive employee's total compensation in that future year to exceed $1 million. If the entity does not expect the covered executive employee's total compensation to exceed $1 million, then the future deductible portion of the covered executive employee's current compensation expense gives rise to a temporary difference under ASC 740. However, if the entity expects the covered executive employee's total compensation to exceed $1 million, then the future nondeductible portion of the covered executive employee's current compensation expense gives rise to a permanent difference under ASC 740.

Evaluating compensation paid to other covered employees

For tax years beginning after December 31, 2026, entities must also consider whether the Section 162(m) limitations apply to any ARPA 5 employees in addition to evaluating compensation payable to covered executive employees. This evaluation involves an incremental complexity because, in addition to determining whether a given employee's compensation will exceed $1 million in a future taxable year when a portion of their compensation becomes deductible, an entity must also determine whether it expects the employee to be an ARPA 5 employee. In other words, an employee's compensation may exceed $1 million without being subject to the Section 162(m) limitation if the employee is neither (1) a covered executive employee, or (2) one of the ARPA 5.

While the Section 162(m) expansion under ARPA does not go into effect until tax years beginning after December 31, 2026, the future impact of ARPA on an entity's ability to deduct employee compensation may have current-period accounting implications. For instance, an entity may have deferred compensation arrangements in place with employees in the current fiscal period that will be settled in a tax year beginning after December 31, 2026. Those entities must consider in the current fiscal period whether any of those deferred compensation payments will be disallowed under Section 162(m) in those future tax years.

Approaches to recognizing the income statement impact of Section 162(m) limitations

Following the issuance of FAS 123(R), *Share-Based Payment* (now codified as ASC 718), the FASB established the FAS 123(R) Resource Group, which discussed the impact of Section 162(m) on the accounting for share-based payment awards using the following example. Assume the following facts:

- Company A's executive employee has a salary that is expected to be $1 million for each year.
- Company A grants the executive employee a share-based payment award of 100,000 shares on 1/1/20X1.
- The fair value of the shares on the grant date is $10/share (the award's total value is $1 million).
- All 100,000 shares cliff vest on 1/1/20X3 if the executive employee is still employed by Company A. Assuming no forfeitures, Company A will recognize $0.5M in compensation expense in 20X1 and 20X2.

Also assume that the fair value of the shares remains constant for all periods, Company A's pretax income is $0 (excluding executive compensation), and Company A's combined federal and state statutory tax rate is 40%.

Tax-planning strategies

The Resource Group discussed under which circumstances Company A may consider tax-planning strategies under ASC 740 when determining the tax benefit for share-based payments potentially subject to the Section 162(m) limitation:

- Tax-planning strategies within Company A's control that would allow Company A to avoid the Section 162(m) limitation may be considered when determining whether the Section 162(m) limitation will result in a permanent difference.
- Tax-planning strategies not within Company A's control (for instance, those that require the executive to make a tax election) may not be considered when determining whether the Section 162(m) limitation will result in a permanent difference.

Approaches to recognizing impact of Section 162(m) on tax benefits from share-based payment

The Resource Group discussed two approaches to recognizing a tax benefit for the share-based payment as compensation cost that would be acceptable under ASC 740:

- *Pro rata* – Under the pro rata approach, Company A would estimate the executive's total compensation subject to the Section 162(m) limitation in 20X3. When determining the share-based payment component of the executive's compensation, Company A would utilize the current fair value of the award and would not anticipate future fair value changes. Company A would then determine the ratio of (a) the taxable amount of the share-based payment award to (b) the executive's total expected compensation in 20X3. Company A would use that ratio to determine the portion of the deferred tax benefit attributable to the portion of the share-based payment that is temporary and the portion that is permanent.

  Applying the pro rata approach to this example, Company A expects the executive employee's tax-deductible compensation to be $2 million in 20X3 ($1 million in cash compensation and $1 million in shares), so the shares would equal 50% of the executive employee's total compensation. Since $1 million of the executive employee's compensation in 20X3 is expected to be deductible, with the other $1 million rendered nondeductible by Section 162(m), Company A would attribute $0.5 million of the deductible amount (50%) to the share-based payment. Accordingly, in 20X1 and 20X2, Company A recognizes $0.5 million in share-based payment compensation expense and a $0.1 million deferred tax benefit ($0.5 million compensation expense x 50% ratio x 40% effective tax rate).

If Company A's employee was not an executive employee but rather one of its ARPA 5, Company A would also need to evaluate whether it expects the employee to be among the ARPA 5 in 20X3.

- *Share-based payment last* – Under the share-based payment last approach, Company A would estimate the executive employee's total compensation subject to the Section 162(m) limitation in 20X3, which is when the share-based payment would become tax-deductible. The amount of tax-deductible compensation would first be allocated to non-share-based payment sources. Any remaining deductible amounts would be allocated among share-based payments on a pro-rata basis (in this example, there is only one share-based payment). In the example considered by the Resource Group, Company A expects the full $1 million of tax-deductible compensation to be absorbed by the $1 million of cash compensation. As such, the entire $1 million share-based payment compensation would be rendered nondeductible by Section 162(m), and no deferred tax benefit would be recognized by Company A in any period related to the executive employee's share-based payment award.

  If Company A's executive employee is not an executive employee but rather one of its ARPA 5, Company A would also need to evaluate whether it expects the employee to be among the ARPA 5 in 20X3.

Grant Thornton insight

We do not believe that the approaches discussed by the Resource Group are the only allowable approaches, and that entities may elect to apply other reasonable approaches if applied consistently. For instance, we understand that, in practice, some entities apply a "share-based payment first" approach.

Impact on the effective tax rate

Under ASC 740, entities are required to make a number of disclosures and estimates on both an annual and interim basis utilizing the entity's effective income tax rate. Nondeductible compensation under Section 162(m) results in a permanent difference between book income and taxable income, impacting an entity's effective income tax rate. Entities should also consider the impact of Section 162(m) when determining their estimated effective annual income tax rate during interim periods and when measuring any deferred tax assets, including those related to compensation paid to employees who are not subject to the Section 162(m) limitations.

Contacts

Graham Dyer
Partner – Chief Accountant,
Grant Thornton LLP
Principal, Grant Thornton Advisors LLC
T +1 312 602 8107
E Graham.Dyer@us.gt.com

Carolyn Warger
Partner, Accounting Principles Group
Grant Thornton LLP
Principal, Grant Thornton Advisors LLC
T +1 617 848 4838
E Carolyn.Warger@us.gt.com

April Little
Principal, Grant Thornton Advisors LLC
T +1 832.476.3730
E April.Little@us.gt.com

Jeff Martin
Principal, Washington National Tax Office
Grant Thornton Advisors LLC
T 202-521-1526
E Jeffrey.Martin@us.gt.com

