Bloomberg Law

Benefits & Executive Compensation News

Tax Change Aside, Companies Stick With Executive Performance Pay

By Madison Alder

Posted Oct. 9, 2018, 2:36 PM

- Tax reform ended deduction used for performance pay
- S&P 500 companies sticking to performance pay

Companies that cut back on performance-based pay for their executives after Republican tax reform eliminated an incentive may be the black sheep in a herd that appears to be adjusting to the change more slowly.

Few companies have followed in the path of those like Netflix Inc., which nixed performance-based cash bonuses for its executives and increased their base pay after the tax bill passed.

Proxy statements filed by two dozen S&P 500 companies show that boards generally recognize the elimination of the tax-favored compensation but don't anticipate changes to the way they compensate their executives as a result.

The Tax Cuts and Jobs Act that Congress passed in December eliminated a deduction for executive pay in excess of $1 million by making changes to Section 162(m) of the Tax Code. The law previously allowed companies to deduct executive compensation above the $1 million cap so long as it was performance-based—a structure that encouraged the pay-for-performance structure.

Although the change could lead to creative methods of obtaining a deduction or a structural shift toward base pay, eliminating the tax break doesn't appear to have an immediate impact on how most companies are planning to compensate their executives in the short-term.

"I don't see companies making radical changes in response to the loss of a tax deduction opportunity," Matt Turner, managing director at Pearl Meyer in Chicago, told Bloomberg Law. Corporations in the U.S. have "widely and deeply" embraced pay-for-performance, he said. "There isn't going to be a willy-nilly retreat from that."

Netflix didn't respond to a request for comment about the move away from performance-based cash bonuses.

David Kokell, vice president at Institutional Shareholder Services and head of its compensation research team, said in a white paper shortly after Netflix's announcement that boards choosing to shift from performance pay to more guaranteed or "highly discretionary" alternatives would "face investor backlash."

Grandfathering Priority

The IRS in August released guidance for the new Section 162(m), taking a fairly stringent approach to the changes. Under Notice 2018-68, the IRS clarified, among other things, that companies may grandfather the deductibility of their compensation plans only if it was part of a written binding contract effective before Nov. 2, 2017.

Companies that can exercise “negative discretion"—meaning they can alter compensation in an executive’s package—will have to look into their specific state laws to determine whether their pay package is, in fact, binding. Negative discretion, even if it isn’t exercised, is fairly common.

Most companies will focus on preserving their deduction under 162(m) by grandfathering any compensation arrangements they can, J. Mark Poerio, an equity and compensation lawyer at The Wagner Law Group in Boston, told Bloomberg Law. After addressing that, companies may get more creative about how they’re going to structure their payout.

Compensation Alternatives

Spreading out compensation over time through deferrals may become a common way to to take advantage of the new 162(m) rules.

“Once a covered employee, always a covered employee. If the company strategically keeps deferred compensation after employment at less than $1 million a year it’s deductible even under the new law,” Ruth Wimer, an executive compensation lawyer at Winston & Strawn in Washington, told Bloomberg Law.

There are other ways companies can avoid nondeductible pay, she said. Companies might choose to give an executive a partnership stake in a subsidiary company so their compensation comes partially from a profit interest. Or companies can increase executives’ participation in qualified plans such as pensions and 401(k)s.

The rule also may change the structure of executive compensation packages now that companies no longer can deduct certain amounts of performance-based pay.

“One thing you’re going to see in response to the changed rule is a decreased use of stock options,” Poerio said.

Using stock options was an easy way for companies to compensate executives for performance because the income from options was generally exempt from 162(m) limits, he said. Now that the options no longer are qualified for a special 162(m) exemption, companies are expected to more deeply consider using restricted stock or deferred compensation, both of which may have a longer vesting period.

Turner said companies also may start using more non-quantitative measurements such as employee safety, product quality, and customer satisfaction to grade performance-based compensation. Environmental, social, and governance investing, known as ESG, also might gain popularity as a measurement factor in compensation.

“We’re already seeing ESG performance in incentive compensation and performance evaluations, but it’s a slow creep in,” Turner said.

Proxy advisory firms, however, generally prefer quantitative measures for calculating incentive pay over qualitative metrics.

To contact the reporter on this story: Madison Alder in Washington at malder@bloomberglaw.com

To contact the editors responsible for this story: Jo-el J. Meyer at jmeyer@bloomberglaw.com; Martha Mueller Neff at mmuellerneff@bloomberglaw.com