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Tax Cuts and Jobs Act Impact on Executive Compensation

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Nearly three months after President Trump signed the Tax Cuts and Jobs Act ("Tax Reform") into law, company management, Compensation Committees, and outside advisors have been evaluating the impact the notable changes to Internal Revenue Code Section 162(m) ("Section 162(m)") will have on executive compensation.

Section 162(m) was first passed into law in 1993, with the intent to rein in executive compensation by eliminating the tax deductibility of executive compensation above $1 million for "covered employees", effectively named executive officers (NEOs), unless the compensation was performance-based. The purpose of the tax law was to "punish" firms paying excessive executive compensation; however unforeseen was the performance-based loophole that has led to the unintended consequence of increased executive compensation post-1993.

Flash forward to 2018; 25 years later, Tax Reform now eliminates the loophole of exceptions of performance-based pay and expands the list of "covered employees." With these changes, companies face the challenge of understanding what impact this will have on their executive compensation programs, often specifically designed to qualify for the performance-based tax deduction, and the loss of tax deductibility.

This article explores CAP's perspective on the implications of these significant changes on compensation programs in 2018 and beyond.

Highlights of the Changes to Section 162(m)

Change: The new rule expands coverage to include any person serving as the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) during the tax year, as well as the three highest paid executive officers other than the CEO and CFO (commonly referred to as NEOs). If a "covered employee" is paid $1 million a year in base salary, that is all the company will be able to deduct and annual performance-based bonuses, stock options, performance-based equity and deferred compensation will no longer be deductible.

Previously, a covered employee was an employee who, on the last day of the company's fiscal year, was the CEO and the highest four paid executive officers. The CFO was excluded due to a change in the SEC's definition of an NEO in 2006. Under the Tax Reform, CFO's will be considered a covered employee as SEC and Section 162(m) rules now align.

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CAP Perspective on Incentive Plan Design: We do not expect wholesale changes to compensation arrangements for executives.

The table below highlights the potential impact on the three major elements of pay for executives.

Pay Element	Impact on Plan Design
Salary	• We do not expect significant changes to base salaries • We may see some companies who have historically capped salary at $1 million slowly exceed it • Driving force in setting base salaries is market competitiveness and not tax deductibility • Expect to continue to see base salary represent 15-20% of the total pay mix for executives
Annual Incentive	• We expect companies to maintain the performance-based design of annual incentive plans, and many to keep current design features (i.e., goal attainment plans, threshold, target and maximum payout opportunities) • Investors and proxy advisory firms endorse transparent and performance-based plans and therefore we do not expect these types of plans to go away • Companies will now have more flexibility in simplifying incentive plan design and administration ▪ Ability to use either negative or positive discretion on final bonus payouts; previously only negative discretion was permitted under the old tax code ▪ Ability to adjust performance goals for any unforeseen circumstance that impacts the financial results; any adjustment to a performance goal will not need to be objective and stipulated in advance ▪ However, companies will still need compelling rationale for use of discretion or adjustments to address shareholder expectations • Individual performance metrics and other more qualitative metrics may increase in prevalence as measures no longer need to be 'objective' • Expect to continue to see annual incentives represent 25-30% of the total pay mix for executives
Long-Term Incentive (LTI)	• While the elimination of the performance-based exception removes a tax incentive to grant stock options, we expect that companies that currently use stock options will continue to do, as they attract, motivate and retain talent ▪ We expect any shifts away from stock options due to lost tax deductibility to be very modest • We expect performance-based LTI to continue to represent at least 50% of the total LTI mix ▪ Performance-based compensation will still be an important tool in supporting business objectives ▪ Proxy advisory firms and institutional investors alike still expect to see companies align pay and performance, with performance-based LTI representing the largest piece of the pie at >50% ▪ Similar to annual incentives, we may see modestly more discretion and adjustments with accompanying rationale • We may see some companies adopting longer vesting schedules to spread out the income realized to maximize tax deductibility • Restricted stock often reflects a smaller piece of the LTI pie for the most senior executives as they are viewed as less performance based; we do not expect that to change • Expect to continue to see LTI represent the largest piece of the total pay mix at 60-65% of the total pay mix for executives

CAP Perspective on Administrative Requirements: Going forward, companies no longer need to follow certain administrative requirements around incentive plans and may need to revisit severance payment timing as certain practices were adopted based on the old tax code.

Additionally, once an executive is a covered employee, they will always be considered a covered employee, even if they appear in the proxy for just one year. Thus, compensation of covered employees for all future years of employment will be impacted, potentially creating an ever-growing group of covered employees subject to the $1 million cap.

The table below highlights the potential impact on these three key areas.

Administrative Requirements	Impact on Plan Design

Incentive Plans	• Stockholder re-approval of incentive plans every 5 years are no longer necessary
	• Approval is only necessary when there is a need to increase shares available, the plan term is set to expire or if there are changes in the plan document
	  ▪ Companies will likely be adopting new plans, rather than amending existing plans to minimize the risk of losing the grandfather status which is further explained later in this article
	• Tax Reform removes the following:
	  ▪ Requirement for shareholders to approve performance metrics and adjustments of performance goals
	    › Companies will be able to use any performance metrics and will not be limited to the shareholder-approved performance goals and adjustments
	  ▪ Requirement to set goals within the first 90 days of a performance period
	    › We do not expect this to change given this is a formality for most companies though it gives committees and management more flexibility if needed
	  ▪ Shareholder approval of individual award limits (other than incentive stock options); however, shareholders may view the elimination of these limits negatively

Severance Payments	• Previously, payments to executives leaving the company were fully tax deductible, as it only applied to NEOs who were employed on the last day of the taxable year in which the deduction was being claimed • Under Tax Reform, severance payments, including distribution of deferred compensation are subject to the deduction limitation • Bonuses or performance-based LTI can now be paid out at target in the year of termination without a different tax consequence; prior to Tax Reform, a company could only claim a tax deduction if the payout was based on actual performance

List of Covered Employees	• The list of covered employees can now grow and may have tax implications of compensation and severance arrangements from an expanded group that will increase over time
	• To the extent possible, companies should try to have a consistent or narrow group of NEOs
	• Companies will want to be careful about unintentionally moving an executive into the proxy for a one year due to one-time payments
	  ▪ If possible, companies should structure those one-time payments in a way that would not cause an individual who would not typically be one of the three highest compensated executive officers to become an NEO for just one year
	  ▪ Companies need to maintain an ongoing list of all "covered employees" and monitor the compensation arrangements that apply to such individuals

Change: Tax Reform included some transition relief. The elimination of the performance-based exception applies to taxable years beginning after December 31, 2017. However, the changes do not apply to compensation provided pursuant to a written binding contract in effect as of November 2, 2017, and are not "modified in any material respect" as of November 2, 2017.

CAP Perspective: Under the "transition rule," deductibility is preserved for compensation provided under a written binding contract in effect as of November 2, 2017, as long as there is not a subsequent material modification. At this time, it is not clear how the transition rule will be interpreted and implemented. While we await further clarification, companies will have to evaluate if they plan to claim a tax deduction under the transition rule based on the limited guidance provided to date, and the specific facts related to the grants / award agreements. During this waiting period, companies should carefully consider any changes to existing arrangements, including outstanding long-term incentive grants, as they could disqualify those arrangements from being grandfathered under the transition rule.

Change: Prior to Tax Reform, under Section 162(m) the definition for "outside directors" was different than the stock exchange rules of "independent directors." The difference is that a former officer could never be considered an outside director but can be independent.

CAP Perspective: The Compensation Committee can now include independent directors who are not "outside directors". We are not seeing companies make changes at this time, as they still need to approve (outstanding) payouts that are grandfathered under annual incentive or performance-based plans. However, we still expect the Compensation Committee to be comprised of "outside directors" given the independence factors. Companies may want to amend Compensation Committee charters to remove any references to Section 162(m) outside director or procedural requirements.

Planning for 2018 and Beyond

Beginning in 2018 companies will lose the tax deduction on compensation over $1 million for covered employees; however, the reduced corporate tax rate will provide an offset to the lost deduction. As companies evaluate the effect of the lost tax deduction and full impact of Tax Reform on their compensation programs, we would recommend companies to work with outside advisors to determine the impact the changes will have their compensation program design, particularly grandfathered performance-based compensation arrangements.

Companies should await further guidance from the IRS, proxy advisory firms and stock exchanges before making substantial changes to their compensation programs. Any change should ensure the appropriate behaviors and results are being rewarded, performance targets are reflective of the long-term strategy, and incentive plan design supports current business needs, while considering good governance practices.