Pearl Meyer

ADVISOR BLOG

To Adjust or not to Adjust? That is the (New Tax Law Earnings Charge) Question

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We've been spending a good deal of time these days talking with people about the new tax law. Probably one of the most complicated things to explain is what's happening with—and what to do about—the relatively huge earnings charges resulting from the new tax law. This attempts to boil it down:

Most, if not all, companies will exclude the earnings charge from their incentive calculations and here's why: these charges are the result of a tax law change. They represent a one-time event that has no impact on operations. While some companies will recognize income and others will recognize an earnings charge, *all* companies will benefit from lower corporate tax rates. If an adjustment is not made, incentive plan participants may reap a windfall (if income is recognized) or have their incentives wiped out (if a large earnings charge is taken).

Whoa—you sound like an accountant—plain English please! Okay, before we start talking about adjustments, let's look at a basic example. Assume a company has a $1,000 reserve (perhaps a loan loss reserve or asset impairment) that has not been expensed for tax purposes. This represents a $1,000 book/tax difference – financial statement income is $1,000 lower than taxable income. At 2017 federal tax rates, this means the company has a deferred tax asset equal to $350 ($1,000 x the tax rate of 35%). However, with the new, lower federal tax rate of 21%, the value of the deferred tax asset is only $210 ($1,000 x the tax rate of 21%). This means that while the deferred tax asset will still offset the $1,000 of future taxable income, the company will not realize the same level of tax relief as it would have at the higher tax rate. An expense (or charge) of $140 ($350 - $210) will be recognized.

Note that capital-intensive companies may have deferred tax liabilities (due to faster tax depreciation than financial statement depreciation) and therefore recognize income, while companies with foreign source income may recognize an earnings charge due a change in the way foreign source income is taxed.

Hmm. That seems to make sense, but not sure that helps me understand the rationale for making an adjustment. We never adjust our financial results when determining incentive payouts—no exceptions—so why would we consider doing one now? The answer depends on a few things:

1. For companies that establish incentive targets based on a budget or other projection, had the impact of the new tax law been known when targets were set, it would have been adjusted out of financial targets.

2. For companies that use relative measures, it may be more challenging to make adjustments, but it should still be investigated. That's because companies will have different issues based on unique circumstances that impact their deferred tax asset or liability—including foreign versus domestic sales, tax strategies, and other company specific factors. Furthermore, peer company earnings charges or income resulting from the tax law change may not be disclosed in their financial statements with enough detail to make meaningful comparisons.

3. For companies that use absolute measures such as an economic value added model ("EVA"), return on equity, or other measures where targets are established based on something other than a budget or projection, further analysis may also be required. In general, even if an absolute target was established, such targets were influenced by the tax rate at the time and any income or expense recognized should probably be excluded.

But won't this be unfair to shareholders? Not necessarily. The lower tax rate is a permanent change and a huge benefit. That's because the value of lower tax rate should far exceed the current earnings charge in the long run *and* it is a non-cash expense. Some companies will recognize income, not an expense.

Of course, as with all compensation decisions, the company should be sure to provide clear disclosure of any discretion the committee exercises—even those resulting from the new tax law.

About the Author

Mark Rosen is a managing director in the firm's Charlotte office. He has consulted on executive and board compensation issues for more than 20 years for a broad range of public companies, as well as tax-exempt organizations and academic institutions. Mr. Rosen has extensive experience with benchmarking, retirement plan design, governance issues, and tax and accounting considerations.

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