Goodbye 162(m), Hello Unintended Consequences

As we ring in the New Year and a new tax bill, it’s time to think about how the elimination of 162(m) could affect executive compensation programs.

As a reminder, Section 162(m) limited the deduction of compensation paid to certain executives to $1M unless it was performance-based. This resulted in larger companies (generally greater than $3B in revenue) limiting base salaries for CEOs to $1M and placing a heavier emphasis on performance-based incentive pay. Larger companies do have salaries over $1M, but 162(m) broke the correlation of company revenue and base salary.

Unintended consequences invariably follow tax law changes. With the elimination of the performance-based exception for performance-based pay under Section 162(m), we are sure to see some trends emerge:

- **Salaries are sure to rise.** Compensation in excess of $1M (for certain executives) will no longer be deductible whether it is performance-based or not. Therefore, there will no longer be a reason to limit salaries to $1M. Salaries will rise, but annual incentive opportunities (as a percent of base salary) will probably not be reduced, resulting in another round of compensation inflation.

- **Goal-setting practices may change.** The reins will be loosened when it comes to the timing of setting goals, which means that boards have more freedom to adjust goals as conditions dictate. Many companies, especially cyclical or commodity-based businesses, often have difficulty in establishing financial goals. Allowing boards to review results at year-end and adjust based on actual business conditions and performance can result in more performance-appropriate incentives. Conversely, executives want to know what they need to do to get paid and without clear goals early, there is an increased risk of confusion.

- **Discretion will likely play a larger role.** Institutional shareholder advisors may not like it, but it will be easier to pay executives more when performance is above expectations. It is easy to say that boards will exercise discretion to reduce incentives when
performance is below expectations, but in practice it is often very difficult.

- **Subjectivity is now in play.** Increasing the portion of the incentive based on subjective performance metrics is a simple change. Varying the relative portion of the objective and subjective metrics can provide the board with more flexibility to reward executives on non-financial measures. This also means that individual performance could be used to modify a bonus earned—allowing for recognition of outstanding individual performance. If an organization’s culture is more team-based, a team-based modifier could be employed. For example, if the incentive based on established goals is to be paid at target, but the team’s performance is determined to be above expectations, the modification could be +10% resulting in an incentive earned of 110% of target.

**What about Long-Term Plans?**

Cash based long-term plans may well mirror annual incentives with more discretion exercised. However equity-based incentives must have objective performance metrics in order to have a “grant date” for accounting purposes. If there is no “grant date,” the expense will vary based on stock price which leads to a variable expense. Therefore, most equity-based long-term incentives will continue to utilize objective performance metrics thus establishing a “grant date” and fixing the expense (at least with respect to the stock price).
About the Author

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