Pearl Meyer

ADVISOR BLOG

Goodbye 162(m), Hello Unintended Consequences

AUTHOR

Mark Rosen
Managing Director

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

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.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management on the alignment of executive compensation with business and leadership strategy, making pay programs a powerful catalyst for value creation and competitive advantage. Pearl Meyer’s global clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private companies to the Fortune 500 and FTSE 350. The firm has offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, London, and Los Angeles.

Pearl Meyer

NEW YORK
461 Fifth Avenue, 19th Floor
New York, NY 10017
(212) 644-2300
newyork@pearlmeyer.com

ATLANTA
One Alliance Center
3500 Lenox Road, NE, Suite
1708 Atlanta, GA 30326
(770) 261-4080
atlanta@pearlmeyer.com

BOSTON
93 Worcester Street, Suite 100
Wellesley, MA 02481
(508) 460-9600
boston@pearlmeyer.com

CHARLOTTE
3326 Siskey Parkway, Suite 330
Matthews, NC 28105
(704) 844-6626
charlotte@pearlmeyer.com

CHICAGO
151 N. Franklin Drive, Suite 450
Chicago, IL 60606
(312) 242-3050
chicago@pearlmeyer.com

HOUSTON
Three Riverway, Suite 1575
Houston, TX 77056
(713) 568-2200
houston@pearlmeyer.com

LONDON
Collegiate House
9 St. Thomas Street
London SE1 9RY
+44 (0)20 3384 6711
london@pearlmeyer.com

LOS ANGELES
550 S. Hope Street, Suite 1600
Los Angeles, CA 90071
(213) 438-6500
losangeles@pearlmeyer.com

For more information on Pearl Meyer, visit us at www.pearlmeyer.com or contact us at (212) 644-2300.