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Viewpoint on Executive Compensation

Opinion Research Alert

The Elimination of the Performance-Based Requirement Under Section 162(m): When it Comes to Executive Pay Design Changes, There is "Less Than Meets the Eye"

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Any changes to long-standing executive pay rules—regardless of whether they concern taxes, accounting, or regulations—raise questions and uncertainty about whether they will lead to wholesale changes in how executive pay is delivered.

This holds true for the recent elimination of Section 162(m)'s performance-based exception, effective in 2018 under the new tax law (certain binding contracts have been grandfathered). Following this tax law change, we expect performance-based pay to remain a key element of executive pay programs. However, some required processes are no longer relevant, and there are opportunities for greater flexibility.

When Section 162(m) was implemented in 1994, executive compensation for covered individuals in excess of $1M lost tax deductibility **but** there was an exception built in for compensation that qualified as "performance-based" with specific rules applying. The performance-based exception was in place from 1994-2017. If companies met the requirements, it offered an *exception* so that many incentive compensation types did not count towards the $1M tax deductibility limit. Starting in 1994, this led to many procedure and approval changes to ensure that as many incentive programs as possible could be tax deductible outside of the $1M cap. It led to shareholder-approved annual incentive plans or omnibus plans, share limits and metric lists in equity plans, goal approval deadlines, and many other procedural changes. It also contributed to some design changes, such as more formulaic annual incentives and the increased use of performance shares over time-based restricted stock.

Key Takeaways

- *The new tax rules eliminate the "performance-based" exception to tax deductibility, removing procedural requirements of IRC Section 162(m)*
- *As a result, companies are given flexibility to design and administer incentive plans*
- *We expect most companies to continue setting incentive goals at the start of the year, emphasizing financial goals, and generally following preset payout formulas*
- *In some situations, companies should use the newly available discretion to consider unplanned events, underlying results quality, and other factors when determining final payouts*
- *As always, in deviating from preset formulas, companies must consider participant and shareholder optics*

However, during the 162(m) rules' 24-year lifespan, *many other factors* contributed to executive pay design: the increased influence of proxy advisors, the adoption of Say-On-Pay, and a stronger voice for shareholders on how the delivery of executive pay could strongly align with shareholder interests. Overall, the trend has continued towards performance-based pay over fixed or time-based pay.

We believe that most current plan *designs* reflect shareholder sentiments and there will be minimal changes—mostly at the margins—in terms of design. We also expect *procedural* changes will become more widespread. We discuss both on the following pages.

To support the premise that executive pay design will not dramatically change, we point to the health insurance industry. In March 2010, the Patient Protection and Affordable Care Act was enacted. This limited the tax deduction to $500,000 per health insurance company employee. We found that health insurance companies did *not* make major changes to their basic executive pay program designs in response to the 2010 statute, and this sector's loss of tax deductibility was much broader than anything the 2018 changes will bring.

We expect the new tax rules to play a negligible role, if any, in executive pay program design changes for most companies: an emphasis on performance-based pay will likely continue to best serve companies. However, as companies vary in their life cycle, near-term objectives, and talent needs, new creative practices may emerge that maintain strong pay-performance alignment while improving the outcomes and logic of pay decisions.

A. Design		
Pay Element	**Projected Design Impact**	**Comments**
1. Base Salary	Minimal	• Investors will not favor large increases to fixed pay • *May see some CEO salary increases above $1M in situations where the company has kept salary at the 162(m) limit even where most peers were above that amount*
2. Annual Incentives/Bonus	Moderate	• More flexibility for qualitative/individual metrics and positive discretion, although we expect these to be used carefully, given proxy advisor and shareholder interest in alignment of pay and financial performance
3. Time-Based Restricted Stock	Minimal	• Performance shares/cash and other at-risk award opportunities will continue to be ≥50% of the officer award opportunity at most companies • Proxy advisors do not want to see >50% of long-term incentive in time-based stock and generally favor a minority (e.g., 25% to 35%) in this form
4. Stock Options	Minimal	• Prevalence and size of stock option grants has diminished due to many factors (dilution, accounting costs, etc.) • However, stock options will continue to be used by high-growth companies and many others as part of an overall stock grant portfolio
5. Performance Shares	Minimal	• Shareholders favor performance-based equity, and we expect prevalence will not change • *There may be small uptick in qualitative metrics, representing a small portion of the total award*

The requirements for documentation and approvals are likely to result in more substantive changes—both in the expanded toolbox of actions that Committees/management can apply and, over time, actual company decisions.

B. Compensation Procedures & Approvals

Category	Projected Procedural Impact	Comments
1. Process and Plan Documentation	Significant	• Eliminates the need for many companies to request shareholder approval of the equity plan at least every five years • *In order to have sufficient share reserve, many companies may still find the need to seek shareholder approval at least every five years*
2. "Umbrella" formulas for annual incentives and/or performance shares	Significant	• Results in umbrella formulas no longer being necessary for tax deductibility • *The use of umbrella formulas may continue for some companies, particularly if this maintains Summary Compensation Table disclosure as a pre-established incentive opportunity* ○ Note: Committees wanting some qualitative metrics have been using umbrella formulas to create a maximum and then applying negative discretion
3. Incentive Measure Selection	Moderate	• Allows flexibility since measures do not have to be listed in the shareholder-approved plan document (existing plan documents may need to be amended, while preserving the tax deductibility of grants made prior to the effective date of the new tax law) • *Companies may decide to more explicitly use non-financial measures, including key strategic factors (e.g., diversity, leadership, quality)*
4. Goal Setting	Significant for after-tax measures; otherwise Minimal	• Makes after-tax earnings comparisons difficult with pre-2018 levels • Results in greater volatility of joint venture earnings • Impacts the balance sheet (deferred tax assets) in the first year
5. Grant Timing	Minimal	• Eliminates the requirement to set goals at the start (e.g., first 90 days) of the performance period • *However, companies and Compensation Committees will view goal setting within the first quarter to be good governance and "best practice"*
6. Adjustments of Known Factors	Minimal	• Eliminates requirement to specify potential adjustments to incentive goals at date of grant • *Most companies already have adjustment guidelines in place given the potential impact of adjustments*

B. Compensation Procedures & Approvals		
Category	**Projected Procedural Impact**	**Comments**
7. Committee Discretion to Change Performance-based Payout Levels	Moderate; in most years, companies will likely strive to follow the preset goals	• Allows positive discretion, which may make sense in certain circumstances for annual incentive and cash-based long-term incentive plans • As a practical matter, companies will want to be thoughtful in deviating from preset formulas to maintain strong incentive effect and pay-performance alignment while considering the shareholder disclosure in the proxy filing and resulting proxy advisor perspectives • *While the flexibility will be welcome, most Committees appreciate the discipline of following preset goals and rewarding their achievement. Any discretion should consider individual grant limits and other terms governing the grants* 　○ Note: Performance share discretion may create variable accounting

Conclusion

While the elimination of the Section 162(m) "performance-based" exception offers greater flexibility with respect to the types of metrics and equity vehicles, and the use of discretion, we believe shareholders continue to want disciplined, performance-based incentive programs. While the guardrails provided by the "performance-based" exception have been removed, it will be important to develop internal guardrails to ensure the Committee and management are aligned in how executive pay is delivered.

There may be trepidation in opening incentive plan administration to wider discretion, particularly as current payout decisions can be challenging even with the limited range of adjustments that Committees consider. If organizations decide to make changes, they should be made thoughtfully with the understanding that discretion, if used, cuts both ways: positively and negatively. The incentive plans must also continue to motivate participants, strongly align pay and performance, and yield a straightforward description in the proxy CD&A on which the Committee and management are comfortable signing their names.

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