

The Newly Revised US Tax Code Will Influence Executive and Employee Pay, but How Much?

In addition to changing to corporate and personal income tax levels, the new tax bill is likely to influence incentive compensation for executives and the broader employee population.

In a highly partisan vote that came down to the final days of 2017, the US Congress struck a deal to pass the Tax Cuts and Jobs Act, which President Donald Trump signed into law on December 22. The bill is the most sweeping tax overhaul in three decades and its hallmark feature is a reduction in the corporate tax rate from about 35% to 21%. This and other provisions, such as the lowering of income taxes for certain tax brackets and changes to key deductions, will impact individuals and corporations in a variety of ways. In this client alert, we focus on the provisions of the bill that could influence the design of incentive pay in the future.

No Tax Deductibility for Performance-Based Compensation Over \$1 Million

Corporate deductions at public companies for executive compensation paid to Named Executive Officers (the CEO, CFO and the next three highest paid officers) will be limited to \$1 million per year, with no exceptions for performance-based compensation. The limit will apply to all compensation, including amounts previously exempted from the limit such as stock options, stock appreciation rights, performance shares and units, as well as restricted stock units and other various forms of nonqualified deferred compensation, severance and certain retirement benefits paid after termination of employment.

The bill applies to any individual who was or who became a Section 162(m) "covered person" for taxable years beginning after 2016, and such individual would remain a covered person for as long as he or she receives compensation from the company.

As a result of this provision, there could be lost tax benefits and effects on a company's income statement. It will be even more important for companies to be mindful of the timing of award vesting and payouts to avoid inadvertent bunching of items into the same time period, causing a loss of deductibility.

This provision would be effective for tax years beginning after December 31, 2017. Amounts payable under a written binding contract that was in effect by November 2, 2017, would be subject to the Section 162(m) rules prior to amendment. We expect the IRS to update existing regulations and guidance to address the amendment and the transition relief.

We do not see the loss of the tax deduction having any immediate impact on the forms of pay used. While investors and proxy advisory firms will still expect a close link between pay and performance, companies may feel

more flexibility under the new tax bill to exercise positive discretion where warranted, because there will no longer be a penalty under Section 162(m) for doing so.

Tax-Exempt Organizations: Additional Tax on Compensation Over \$1 Million

The final bill also provides that if a tax-exempt organization pays compensation to any of its five most highly compensated employees in excess of \$1 million (subject to certain exclusions), the organization would be liable for a 21% tax on excess amounts. (The excise tax rate is tied to the amended corporate income tax rate.) This provision applies to amounts paid, or included in income under Section 457(f), during taxable years commencing after December 31, 2017. Like the amended Section 162(m) provision explained above, the determination of the five most highly paid employees begins with tax years commencing after 2016. If an individual became a covered person under this section, such individual would remain a covered person for as long as he or she receives compensation from the organization.

The bill also imposes a 21% tax on excessive amounts contingent on separation from service paid to such covered employees. This provision is somewhat similar to the golden parachute change-in-control provisions under Section 280G— meaning it only applies if the present value of the contingent amounts equal to or exceeding three times the employee's average taxable wages during the preceding five year period. If the contingent amounts equal or exceed this safe harbor, the tax applies to the amount in excess of one times the five-year average. This provision does not apply to amounts paid under Section 457(b) or qualified plans.

Delayed Tax Payments for Startups Giving Stock Options and Stock Settled Restricted Stock Units

Under the bill, employees at private companies where stock options and stock-settled restricted stock units are provided to at least 80% of the workforce in a given calendar year can elect to defer recognition of taxable income for up to five years when they exercise those options or receive a stock settlement. (Certain conditions under this new provision, such as the company going public, can trigger earlier taxation.) Executives and certain high-earners are exempt from this provision.

Gains from stock option exercises and shares received upon settlement of restricted stock units are taxed as wages, which can be a burden for employees because the shares aren't typically liquid until the company is publicly traded. With companies taking longer to go public these days, this provision could be seen as a big benefit for employees of startups.

In the long run, this provision could prompt more private companies outside of the technology and life sciences sectors to award options more widely due to the 80% requirement.

Special Bonuses or Salary Increases

Several large companies have announced they will use tax savings from the bill to reinvest in their employees via incentive pay and higher salaries. Fifth Third Bank [said](#) it would boost the minimum pay for its employees to \$15 per hour as a result of the tax bill. AT&T [said](#) it will pay a special \$1,000 bonus to more than 200,000 of its non-management workers. Comcast [announced](#) it will give a special \$1,000 bonus to more than 100,000 non-executive employees as well as invest \$50 billion over the next five years in infrastructure improvements. Boeing, Wells Fargo and others have made similar announcements.

According to media reports, at least two dozen companies have already initiated significant stock buybacks, corporate dividend increases or a combination of both leading up to the bill's passage— all of which are intended to boost stock returns and make investors happy. Proponents of the bill say companies will also reinvest their tax savings into boosting pay for workers, hiring for more jobs, and investing in training programs. At Radford, we plan to monitor our data on bonus pool funding and projected salary budgets for signals that companies are actually investing more in compensation in 2018.

Next Steps

We recommend clients take the following steps to best position your organizations for certain changes to the tax code:

- If you are company whose tax year-end is other than December 31, there may still be an opportunity in 2018 to lock in a tax benefit at a higher rate by meeting the “all events test” for a bonus accrual before your fiscal year-end or by accelerating the vesting (and settlement) of any restricted stock or restricted stock units that will otherwise vest shortly after your fiscal year-end. Generally, a short acceleration of vesting will result in a small acceleration of the related book expense, but the tax gain of doing so should offset the expense. Accelerating the vesting should not result in your employees having taxable income recognized in a different tax year because employees’ tax year end will occur after vesting.
- Begin considering how the change in corporate tax rates may affect the results of your incentive performance metrics and determine if adjustments in the performance score should be made for outstanding cycles. Also consider how the change in rates may affect the goals you set for any new performance cycles. We recommend consulting with an equity compensation expert to determine whether there is a material impact to your equity performance goals, and how modifying these goals could trigger incremental expense. For current performance cycles, companies should plan on normalizing final performance results so that the change in tax law does not cause an undue windfall to executives. This can occur in cases where performance metrics might include return on equity and show more favorable results due to a lower corporate tax rate.
- Make sure you have properly catalogued the performance-based compensation as well as compensation that may be paid following termination of employment that is eligible for Section 162(m) transition relief. This helps ensure that you do not inadvertently give up a valuable tax deduction for a covered employee.
- Maintain an inventory of the tax years in which covered employees will receive compensation to possibly avoid inadvertently bunching income that exceeds the \$1 million limit.
- Consult with others in your company or organization with respect to tax, accounting and financial reporting implications of the tax reform bill. Also consider whether there would be any impact on your 2018 earnings guidance to the investment community.
- Consider updating 162(m) language in plan documents and committee charters as a matter of good housekeeping.

To speak with a member of our compensation consulting group about the tax bill and related changes to incentive compensation, please write to consulting@radford.com.

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