Taxing times—US tax reform and the impact on executive pay

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Share Incentives analysis: After a year in office, the presidency of Donald Trump achieved its first legislative change, on the bread and butter Republican issue of tax reform. Gillian Emmett Moldowan, of Shearman and Sterling LLP in New York, assesses the typically controversial upshot of the reform, and what it means to senior executives.

Can you provide a summary of the main US tax changes affecting executive pay and employee incentives?

The key issue being dealt with immediately relates to section 162(m) of the Internal Revenue Code (IRC). Section 162(m) prohibits publicly held corporations from deducting more than $1 million per year in compensation paid to each of certain ‘covered employees’.

There was historically an exception to this rule for performance-based compensation (a critical piece of most executive compensation programmes), and as such, performance-based compensation was previously fully deductible as long as certain approvals were first provided (ie shareholder approval of performance measures and certain other compensation plan terms, board approval of specific performance compensation programmes and certification of the performance measures).

With that exception eliminated, but the $1m limit not, public companies cannot deduct those amounts paid to its covered executives. Prior to the reforms, the roles of these covered executives included CEOs and the next three most highly-compensated officers as named in annual disclosures (ie the named executive officers other than the CFO). CFOs have traditionally been excluded and so did not have the $1m limitation, but will now be considered covered executives and thus subject to the limitation. Further to this, if an employee has historically been a covered person, they remain so even if they move roles within a company.

This change will have significant impacts on how public companies structure annual compensation going forward, not least because there were a number of formalised hoops that companies would have to jump through to ensure compensation being paid was in line with the rules allowing for the deduction.

There are grandfathering rules to section 162(m) of the IRC so that payments under certain arrangements that existed prior to 2 November 2017 will still be deductible, but we are waiting for guidance on exactly which arrangements will be grandfathered.

From a tax perspective, therefore, compliance with the rule (other than for grandfathered arrangements) is no longer meaningful, but it will be interesting to see if this results in a shift in the culture of compensation tied to performance measures. Such compensation strategies have previously been used in conjunction with other incentives, or to promote good governance. Without the existence of the deductions in the new rules, this will be the most impactful change we are likely to see.

For private companies there is now a new Tax Code provision—section 83(i) of the IRC—which allows companies to defer—for up to five years—tax income events with respect to certain equity awards (exercise of options and settlement of restricted stock units), which will help manage liquidity concerns associated with these types of awards. Under US tax principles, when you become entitled to property, in this context, this is generally defined as an income event.

What can be particularly challenging at private companies is matching the income inclusion event with liquidity. At a private company, if you allow the tax event to occur, allowing the person to become entitled, they attain a right but not the underlying liquidity therefore an employee can have an income tax event without the ability to realise cash from the assets and therefore with no suitable way to pay for the tax incurred.

Section 83(i) of the IRC is trying to deal with that complication by allowing the exercise of shares or transfer of shares under restrictive stock units without the immediate tax event. The impact of this rule will be interesting to observe. It is only available when the award is structured in a very specific way, including that more than 80% of US employees have been granted stock within a calendar year. Some companies operate like this, but not all, especially those of a smaller status, and we will have to wait and see whether companies will grant equity awards that enable them to take advantage of the new rule.

There are other changes that will impact compensation structures in the tax reform, but the above changes are likely to have the biggest and most immediate impact.

What is the main impact of the Tax Cuts and Jobs Act 2017 on executive pay and employee incentives?

The new rules, for the most part, are not necessarily helpful. This tax reform focused a lot on reducing tax rates with corporate tax rates dropping significantly and individual tax brackets dropping as well. In order to fund this loss of tax revenue, the administration went through and removed other deductions under a banner of simplification resulting in lower tax rates justified by fewer deductions.

Some of the thought behind how this is put in place is indeed simplification, but that simplicity is one in principle rather than in practice. Most of the rules on executive pay remove the opportunity for deductions, including for employee expenses such as home moving expenses and certain business expenses and deductions for entertainment.

The ability to defer tax events might be of help, although the elimination of the performance-based compensation exception to section 162(m) of the IRC and the creation of a new tax on not-for-profits if an employee receives more than $1m a year will be problematic.

All that said, overall it is hard to know if a company will end up paying more or less tax with the new lower tax rates but the removal of multiple deductions.

What are companies currently doing in response to the tax reform in respect of tax planning initiatives? How will the reforms affect executive pay in the future?

Companies are now trying to assess how these changes will impact their tax planning. In the case of section 162(m) of the IRC, companies are looking at whether to restructure their performance programmes, including making them more flexible, now that they do not need to comply with the old rule. Without the deduction opportunity afforded by meeting the previous rules, decisions about performance and pay will be a purely business and governance based one. Certain companies, particularly non-profits, will be thinking of how to restructure employee compensation so that employees do not earn in excess of $1m a year. In the US, this change mostly will impact universities, hospitals and certain large non-profits—smaller non-profits who are not paying in excess of such amounts are unlikely to be impacted.

We are now waiting on additional guidance from the Internal Revenue Service (IRS). US Tax Code is a statute approved by Congress and then followed by a regulatory process in which administrative agencies such as the IRS look at the statute and create appropriate regulations—those regulations provide further guidance on how the IRS will interpret the statute. Once we have these regulations, we will have more information from the IRS on what, for example, will be considered a binding contract in the grandfathering rules of section 162(m) of the IRC.

Are there any other issues you think worthy of attention?

The profession is taking these changes seriously, they are now law and this is not a wait and see situation. There is no reason to believe that in any immediate time frame there might be repeal or reversal. A new president could change some of the fundamental exceptions, but that is not typically how the US tax code has evolved—just as we have not seen the much talked-about repeal by the Republican Party of the Dodd-Frank Act, which put regulation of the financial industry in the hands of the government, there is no clear reason to assume that the Democrats, re-elected, would set about reversing these tax changes.

It is also worthy of note that some of the proposed changes in earlier versions of the Bills, while complex to implement, might have resulted in real simplification of US tax law that, in the end, this reform does not deliver. Earlier iterations, for example, had attempted to repeal the highly complex law of section 409A of the IRC, introduced in the wake of the Enron scandal. Section 409A is very complicated, hard to pass and requires great expertise in order to create a working compensation programme. Had this made it to the final reform, it would have had greater impact than those changes currently going through and it would have simplified things in the long term. It is hard to say how the final package has fundamentally simplified anything—in essence it is a case of removing deductions to fundraise for a lower rate.

Interviewed by Julian Sayarer.

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