Why Companies May Be Rethinking Executive Compensation in 2018

Marta Moakley January 18, 2018

Evolving corporate tax realities are providing corporate America much food for thought in 2018. Companies may be reconsidering executive compensation programs that reward pay for performance in favor of higher salaries that are freed from any performance tether.

Although multimillion-dollar equity-based bonuses have been a mainstay of executive compensation planning and design for some time, a provision in the federal tax reform law is affecting the deductibility of these bonuses, and, as a result, whether these performance bonuses are offered at all when designing executive compensation.

But corporate considerations shouldn't stop at tax rates when redesigning executive compensation: there are other factors that a company should consider before rethinking pay-for-performance initiatives.

Increased Tax Bill on Executive Bonuses

The federal tax reform law passed in late 2017 contains new compensation deductions limits.

The law repeals the Clinton-era exceptions to the $1 million deduction limitation for commissions and qualified performance-based compensation under the tax code. Effective January 1, 2018, any performance-based compensation or commission paid to an employee covered under the law that exceeds $1 million is not deductible.

The tax reform law also expands Securities and Exchange Commission (SEC) reporting requirements. Employees now covered include a corporation's Chief Financial Officer (in addition to the CEO and the other three highest-paid employees). The law also extends the applicability to corporations that are required to file reports under the Securities Exchange Act of 1934, even if their stock is not publicly traded (e.g., a foreign company publicly traded in the US in the form of American depositary receipts).

The Clinton-era exceptions were enacted, in part, to stem the growing tide of multimillion-dollar compensation packages for executives, which were viewed (particularly by the Clinton Administration) as

excessive. At that time, tying pay to performance was meant to counteract any disproportionate executive pay.

Instead, the opposite has occurred over the past 20 or so years. Corporations supplanted all-cash compensation in favor of performance-based bonus packages, and executive compensation continued its rise. Compensation planning relied on stock-based instruments, with studies showingthat "from 2009-2016, performance share prevalence increased from 50% to 88%, stock options decreased from 70% to 59%, and restricted stock increased from 46% to 59%."
With the new limitation on compensation deductions, however, corporate boards are considering whether to simply raise salaries of top executives and eliminate any program that ties executive pay to company performance.

Case in Point

Companies may be able to offset an all-cash compensation expense with the tax reform's accompanying decrease in the overall corporate tax rate. The accompanying tax relief to the decreased compensation deduction may allow companies to simply walk away from performance-based pay for executives.
Before ringing in 2018, Netflix took swift action and eliminated its stock-based bonus structure in favor of multimillion-dollar raises to executives' base salaries. The cash compensation is not tied to performance metrics.

But would any compensation planning change at the top require a corresponding change in the organization's overall compensation design and pay-for-performance philosophy? Would redesigning an executive's compensation affect an organization's culture of accountability – one that links remuneration to goal achievement?

Optics

Any rethinking of pay-for-performance compensation policies (whether executive or company-wide) undertaken by a corporation will have consequences.

As one columnist put it, Netflix raising executive salaries and rescinding its short-lived tier pay-for-performance program proves that performance-based pay "was always a sham, anyway." Skeptics saw performance-based bonuses as a mere work-around to the deduction exception in the pre-reform tax code, with the understanding that an executive's performance expectations would always be met.
Doug Chia, Executive Director of the Governance Center for The Conference Board, a global, independent business membership and research association, agrees that there will be certain companies that play "into the narrative of critics that boards and executives are just in it for the money."

And executive compensation is scrutinized from many angles. Among those voicing opinions on C-suite pay are:

- Investors;
- Regulators;
- Competitors;
- Labor organizations; and
- Rank-and-file employees.

The SEC-required Compensation Discussion and Analysis (CD&A) disclosures in proxy statements, shareholder advisory votes on executive compensation (say-on-pay votes) and the upcoming CEO pay ratio disclosure requirements (potentially showing eye-popping pay discrepancies between CEOs and employees) all shine a light on executive compensation levels, policies and practices.

Because many corporations have been focused on tying increased executive compensation to performance metrics, a swift, stark change would merit some explanation to stakeholders. Chia warns that “investors are watching.”

Where to Go from Here

Because corporations have many options with respect to compensation design, Chia explains that “it’s hard to predict what changes are going to be made. Companies are trying to figure it out.” But even if these deduction limits don’t decrease executive compensation to a level that satisfies critics, Chia notes that “moving away from equity compensation is a good thing overall; too much of executive compensation is tied to equity-linked instruments.”

Chia clarifies that an overreliance on non-cash stock-based compensation may lead to an “obsession with stock-price,” and to a corporation that is “hyper-focused” on making decisions that make sense in the shorter term. A balanced approach to compensation planning that includes a move away from stock options and restricted stock may result in corporations “investing for the long term,” Chia states.

In addition to an increased emphasis on taking the long view, Chia has confidence that corporations will make informed, “enlightened” choices. He says companies often “do what’s best” from a corporate governance perspective, taking into account investor feedback and compliance requirements.

After “trying out different things,” Chia predicts that there will be “some kind of shift to conform,” signaling a new normal for executive compensation.

But for the time being, debates will no doubt continue regarding the effectiveness of pay-for-performance incentives, the fairness of CEO pay and the optimal design for executive compensation plans.