Energy Insights

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THE END OF DEFERRED COMPENSATION?

Proposed Legislation Could Render the Tax Saving Effectiveness of Deferred Compensation Inert

Posted by Jonathan Szabo on May 15, 2014

Our last post introduced some thoughts around proposed legislation by the Republican Chair of the House Ways and Means Committee that would effectively end tax deductibility of compensation under IRC Section 162(m). I'd like to explore the other aspect of the proposed legislation that would make deferred compensation taxable as soon as it is no longer subject to substantial risk of forfeiture. In other words, this legislation could render most deferred compensation and other nonqualified retirement arrangements obsolete as a tax-effective savings mechanism.

There are several possible outcomes on executive compensation design if deferred compensation disappears. In fact, this new legislation could actually enhance alignment of compensation plans with long-term investor interests as retirement plans are potentially replaced with equity vehicles.

- Companies might extend vesting or performance periods to lengthen the risk of forfeiture period, which would strengthen alignment with shareholders
- More LTI could be awarded in time-based restricted stock, potentially with 5 to 7 year vesting (or up to 10-year vesting like ExxonMobil), enhancing retention
- Stock options could experience a revival, where executives have the ability to elect to take cash compensation in stock options to permit some flexibility in the timing of taxation

While shareholders want performance-based LTI, companies may not feel comfortable setting long*er*-term goals than today's standard of 3-years. However, the energy industry tends to make relatively long-term strategic decisions in capital investment and asset development, and could lead the pack in truly *long-term* performance plans.

Not all of the potential outcomes are shareholder-friendly. Extended restriction or performance periods might lead to larger award values, which in turn cause higher run rates and increased shareholder dilution as companies need larger share pools for compensation. A disappearance of deferred compensation plans might result in executives diversifying their holdings and weakening alignment with shareholders, since there might not be an automatic transfer of funds into a company stock vehicle.

Since longer restriction periods would enhance retention hooks, the already competitive market for talent in the energy industry could become even hotter. Cash compensation levels could increase as companies might have to pay more to induce executives and technical professionals to change companies.

While the future of this legislation is uncertain, the fact that it was introduced by a Republican might signal a shift in the GOP's thinking around taxes, and it might gain bi-partisan traction. At least we wouldn't have to deal with 409A anymore…

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