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SHAREHOLDERS WILL LIKELY FEEL THE PAIN OF PROPOSED TAX REFORMS

Changes Intended to Address Executive Compensation Will Likely Have a Larger Effect on Shareholders

Posted by Tom McNeill on April 22, 2014

As noted in a recent Meridian Client Update, a comprehensive draft proposal to reform the Internal Revenue Code (IRC) was released in February by the Chairman of the House Ways and Means Committee. Among the proposed reforms is the elimination of the tax deduction of compensation earned under performance-based compensation (including stock options).

The proposal reflects the most recent legislative efforts to target executive compensation. Most interesting is that the bill was introduced by Republicans, indicating that the GOP may be changing its position on certain tax legislation. Ironically, legislation of executive compensation in the past arguably led to significant unintended consequences – see Sections 162(m) and 280g.

If performance-based compensation were no longer deductible, it's unlikely that committees would make many changes to the design of their pay programs or pay levels. Therefore, compensation levels would not be reduced and the companies would simply pay higher taxes. So, who will really feel the pain? The answer is that shareholders will likely be hurt by the proposed changes more than executives, as the loss of deductibility would reduce companies' earnings per share and impact stock valuations.

Within the energy industry, the loss of deductibility of performance-based compensation would be significant, given energy companies' heavy focus on incentive compensation. The chart below shows the deductibility of compensation under current law and the proposed House bill based on a hypothetical CEO's compensation paid during a calendar year:

Form of Compensation	Illustrative CEO Pay (millions)	Under Current Law	Under the Draft House Legislation
Base Salary	$1.00	Deductible (first $1 million of non-performance based compensation is deductible)	Deductible (first $1 million of compensation is deductible)
Incentive bonus payout (linked to achievement of shareholder-approved performance metrics)	$1.25	Deductible	Non-deductible
Exercise of stock options	$2.00	Deductible	Non-deductible
Payment of performance shares	$2.50	Deductible	Non-deductible
Vesting of time-vested restricted stock	$1.25	Typically non-deductible	Non-deductible
Total Compensation	$8.00		

Under current law, a deduction may be taken for $6.75 million of the $8.0 million of compensation paid to the CEO. The draft House bill would reduce the deduction to $1.0 million representing a loss of deduction equal to $5.75 million. Assuming a 40% corporate tax rate, this would reduce the company's after-tax earnings by approximately $2.3 million.

The proposed House bill and other similar legislation are unlikely to move forward at least until after mid-term elections. However, they likely signal that executive compensation issues are once again a brighter "blip" on the Congressional radar screen. We suggest that companies continue to maximize the deductibility of their executive compensation programs under 162(m) while they can.