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“Say on Pay” Hasn’t Gone A-Way Under Tax Reform, Reminds ISS*

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Internal Revenue Code Section 162(m) imposes a $1 million limit on the amount most public companies can deduct for compensation paid to any “covered employee.” The Tax Cuts and Jobs Act (the Act) significantly changes Section 162(m) by eliminating the exception for “qualified performance-based compensation,” expanding the “covered employee” group and expanding the definition of “publicly held corporation.” Compliance with the now-defunct qualified performance-based compensation exception to Section 162(m) required covered companies to, among other things, periodically seek and obtain shareholder approval of executive compensation packages tied to objective performance goals. (To learn more how the Act impacts 162(m), see here and here.)

The elimination of the qualified performance-based pay exception to 162(m) arguably creates incentives for public companies to attempt to implement fixed or highly discretionary, rather than performance-based and objective, pay programs for their most senior executives. Although the Act’s elimination of the technically-rigorous Section 162(m) performance-pay exception provides employers with greater flexibility in structuring incentive compensation awards for senior executives (such as by setting performance goals greater than 90 days into a performance period, or retaining positive discretion on award payouts), that discretion remains subject to the backstop of the broader (albeit non-binding) Dodd Frank “say on pay” framework and Institutional Shareholder Services (ISS).

David Kokell, head of US compensation research at ISS, recently emphasized this point in an interview. Mr. Kokell asserts that ISS will continue to recommend voting against executive pay awards that are not reasonably linked to “rigorous and transparent performance goals.” He clarified that although the Section 162(m) deduction was a supporting factor in the selection of performance-based executive pay designs, it was “seldom a primary reason behind investors’ expectation for performance-based programs, or a driving factor in ISS’ analysis of pay for performance. As in previous years, changes that generally reduce the transparent and objective pay-and-performance alignment between shareholders and executives will be viewed negatively when [ISS] evaluate[s] compensation pay-for-performance.”

Although Mr. Kokell emphasized that he expects “any board that eliminates or reduces performance-conditioned incentives in favor of guaranteed or highly discretionary pay . . . to face investor backlash,” he advises those public companies that may be considering significant redesign of their executive pay schemes in light of tax reform to communicate early and often with shareholders regarding planned changes.

Companies should carefully consider these issues when navigating their executive pay programs following the Act.