Trump Tax Proposal Could Create Compensation-Related Opportunities

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The Trump administration's proposed overhaul of the federal income tax system includes a reduction of the maximum federal corporate income tax rate from 35 percent to 15 percent. If enacted, the proposal — a one-page outline released on April 26, 2017, and titled "2017 Tax Reform for Economic Growth and American Jobs" — would introduce sweeping changes and simplifications to the federal income tax system.

While the corporate income tax rate is unlikely to be cut to 15 percent, considerable bilateral support exists in Congress for a significant reduction. Any change also would alter the value of corporate income tax deductions. For example, a deduction taken by a corporate taxpayer on a $1 million payment at a 35 percent rate is worth $350,000, while a deduction on the same amount at a 15 percent rate is only worth $150,000.

A change in value of corporate tax deductions could, with proper tax planning, provide opportunities for substantial savings on compensation plans and arrangements. In the short term, potential savings would be possible from tax deductions on annual cash bonus payments and retirement plan contributions, while the long-term impact could involve significant changes to the structuring of compensation plans.

Potential Savings From Payment of 2017 Annual Cash Bonuses

If the maximum federal corporate income tax rate is reduced as of January 1, 2018, corporate taxpayers who pay annual bonuses to executives and other employees based on the 2017 calendar year may be able to deduct those payments in 2017, rather than 2018, and thereby take advantage of potentially more valuable tax deductions. There are three general ways in which a corporate taxpayer is permitted to deduct payment of a 2017 annual cash bonus in the 2017 tax year:

1. Pay the bonuses by no later than December 31, 2017.
2. Determine the amount of the bonuses by no later than December 31, 2017, provide that any executive or other employee who remains employed through that date will receive their bonuses and pay the bonuses by no later than March 15, 2018.
3. Establish a specified bonus pool by December 31, 2017, and unconditionally commit to pay the entire pool amount to executives and other employees by March 15, 2018. Payment can be conditioned on continued employment through the payment date (rather than December 31, 2017), but in order to take the deduction in 2017, the corporate taxpayer must pay out the entire amount of the pool. This would require the corporate taxpayer to reallocate any payment that would have been made to a recipient who is no longer employed at the payment date to other potential recipients who remain employed through the payment date. Alternatively, if by the December 31 deadline the corporate taxpayer is unsure of the total amount of bonuses it may pay for 2017, it could conservatively determine the minimum amount it expects to pay and preserve the 2017 deduction for that amount. Any additional amounts would be deductible in 2018.

Since many corporate taxpayers have already established the terms and conditions of their 2017 annual bonus plans, care must be taken to ensure that any changes to payment dates or other terms do not violate existing contracts or otherwise run afoul of applicable tax rules (such as Sections 162(m) or 409A of the Internal Revenue Code).

Potential Savings From Tax-Qualified Retirement Plan Contributions

Corporate taxpayers are generally eligible to take a tax deduction for contributions made to tax-qualified retirement plans, subject to certain limits. For example, the maximum deductible contribution to a tax-qualified defined benefit plan is based on the funded status of the plan, but it also incorporates a "cushion amount" that generally allows the taxpayer to deduct contributions in excess of the amount needed to satisfy funding requirements under the Internal Revenue Code.

Employer contributions to defined benefit plans are typically significantly lower than the maximum deductible contribution limits, thereby providing most corporate taxpayers the opportunity to increase their contributions while the corporate tax rate is 35 percent in order to maximize the value of related deductions. Companies considering this approach will want to understand the possible effect of these additional contributions on their minimum required contributions in later years.

Internal Revenue Code Section 162(m) Structuring Alternatives

Section 162(m) of the Internal Revenue Code prohibits publicly held corporations from deducting more than $1 million in compensation in any single calendar year to certain covered employees. The limit on deductible compensation does not apply to compensation that meets stringent rules relating to "qualified performance-based compensation," which generally require that compensation be contingent on the attainment of one or more pre-established, objective performance goals set by the compensation committee that cannot be changed once determined.

Publicly held corporate taxpayers have gone to great lengths to ensure that their cash and equity-based incentive plans comply with these often inflexible performance-based compensation rules in order to avoid loss of the related tax deduction. However, if federal corporate income tax rates are reduced — thus making the related deduction less valuable — corporate taxpayers may want to consider whether the benefits of the tax deduction continue to outweigh the burdens of developing, administering and operating incentive plans that make it difficult to adjust to changing business concerns or broader fluctuations in the market.

If a publicly held corporate taxpayer determines that compliance with Section 162(m) is no longer desirable, it could structure incentive compensation in any manner that best serves its business needs, including purely discretionary bonuses or the use of subjective performance goals. The taxpayer should take care in developing its new incentive compensation structure and in communicating it to shareholders and other relevant parties (*e.g.*, Institutional Shareholder Services and Glass Lewis) to avoid adverse consequences for "say-on-pay" votes and related matters.

Conclusion

While President Trump's tax proposal is still in the initial stages and the ultimate terms and effective date of any eventual changes are not yet clear, corporate taxpayers should consider starting the planning process now in order to take advantage of any changes that are ultimately made.