Considering the Risks of Accelerating 2012 Bonus Payments

With continuing uncertainty regarding the nation’s finances fueled by current election banter, executives are faced with the temptation to accelerate payments into 2012 to avoid increasing income tax rates. If Congress does not act, the typical executive could save in excess of 5%1 of the amount of the payment. In reviewing these requests, board members are advised to consider the old adage, “There is no such thing as a free lunch.”

Companies have accelerated payments to executives in the past to avoid tax rate changes. Most notably, in late 1993 a significant minority of companies accelerated executive bonus awards that otherwise would have been paid in 1994, to avoid the uncapping of the 1.45% Medicare tax. Unfortunately, tax increases under presidents George H.W. Bush and Bill Clinton did not provide the same opportunity for tax planning.

With the risk of Bush-era tax cuts expiring, board members could be asked to consider acceleration of incentive payments for their organizations. Should your board be asked to weigh in on this issue, we suggest you consider the following.

- While the request is typically for the benefit of senior executives, the benefit of accelerating income may go well beyond the executive ranks. Nearly all full-time wage earners could face a tax increase of at least 3%. Given the public concern over exceptional treatment of executives, particularly the CEO, we suggest boards discuss whether a limited action only benefiting senior management is appropriate, or whether an all-or-none approach may be warranted.

- While the executive may save 5% in taxes, the acceleration has an economic cost to shareholders. It is objectively fair to assess the economic cost of the accelerated payment at the company’s cost of incremental debt. While some companies are currently experiencing very low borrowing costs, for others, the 2 ½ month advance payment will likely have an economic cost to shareholders of 2-3% or more. While this economic cost is not an expense reported on the summary compensation table it is a cost incurred by the company and should be part of an informed discussion.

- There are consequences of accelerating payment in terms of making individual or organization performance assessments and in terms of protecting the company in the event of and termination of employment prior to the end of the performance period. Board members should consider whether contractual protections are warranted to clawback or adjust any award made in error or made prior to a having a full appreciation of company and individual performance over the entire performance period. Further, an

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1 i.e., Reversion of the top tax bracket from 35% back to 39.6%, plus the impact of reinstatement of the phase out of itemized deductions.
advance payment that is contingent upon later results could conceivably constitute a loan specifically prohibited by Sarbanes-Oxley\(^2\).

- There may be risks to the company’s public image and brand. Given the level of public scrutiny currently provided executive compensation, it is not inconceivable that the act of taking exceptional action to avoid taxation for executives may draw the company and the board into a public debate they cannot win. Keep in mind that the rationale for the acceleration would likely require some narrative in the Compensation Disclosure and Analysis section of the proxy statement.

- Lastly, there could be tax consequence with accelerated payment. Most companies’ 162(m)-qualified plans require compensation committee certification of results and prohibit “positive discretion. Any acceleration could potentially jeopardize the company’s tax deduction for the award.

Clearly, we do not consider the acceleration of payments to be a “slam dunk” decision. While it may be appropriate and non-controversial under many circumstances, such a decision can only be made by a board when benefitting from a full appreciation of each organization’s unique facts and underlying economics.

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Jeff McCutcheon works with a number of boards of directors on executive pay and employment terms, succession and executive performance issues. Mr. McCutcheon’s bio is available at [http://www.boardadv.com/team.php](http://www.boardadv.com/team.php). If you have any question or comments on this article, or want to speak with Jeff about any executive rewards, performance, or succession issue, he can be reached at 904) 306-0907.

\(^2\) Section 402 of Sarbanes-Oxley prohibits companies from making loans or arranging credit for named executive officers. Public companies should seek legal advice prior to accelerating payments to executive officers.