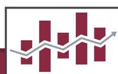

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TAXES AND EXECUTIVE COMPENSATION

BY STEVEN BALSAM

The topic of executive compensation has long been of interest to academics, the popular press, and politicians. With the continued increase in executive compensation and resultant increase in pay disparity between those executives and the average worker, this issue is once again coming to the forefront of the public policy debate. Over the years, lawmakers have tweaked the tax code to limit disfavored forms of executive compensation, while regulators have increased the amount of disclosure companies must make. In the current Congress, Rep. Barbara Lee (D-Calif.) has introduced the Income Equity Act of 2011 (H.R. 382), which would amend the Internal Revenue Code to prohibit deductions for excessive compensation for any full-time employee; compensation is defined as "excessive" if it exceeds either $500,000 or 25 times the compensation of the lowest-paid employee, whichever is larger.

The objective of this study is to examine the impact of a prior limitation on deductibility of compensation, Internal Revenue Code Section 162(m). In contrast to much of the debate today on the need of the federal government to raise tax revenue, the primary goal of Section 162(m), which limited tax deductions for executive com-

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pensation, was not to raise revenue but to reduce excessive, non-performance-based compensation—in other words, to do something about excessive compensation that 1992 presidential candidate William Jefferson Clinton campaigned against. This paper will review the effectiveness of that provision in achieving its goals, and provide information on how much revenue it has raised or lost due to deductions for executive compensation. With respect to reducing excessive, non-performance-based compensation, many consider Section 162(m) a failure, including Christopher Cox, the then-chairman of the Securities and Exchange Commission, who went so far as to suggest it belonged "in the museum of unintended consequences." Sen. Charles Grassley (R-Iowa), the then-chair of the Senate Committee on Finance, was even more direct, saying:

> 162(m) is broken. … It was well-intentioned. But it really hasn't worked at all. Companies have found it easy to get around the law. It has more holes than Swiss cheese. And it seems to have encouraged the options industry. These sophisticated folks are working with Swiss-watch-like devices to game this Swiss-cheese-like rule.

Since Section 162(m) passed nearly 20 years ago, both academic and practitioner research has shown a dramatic increase in executive compensation, with little evidence that it is more closely tied to performance than before. In this paper, we estimate that corporate deductions for executive compensation have been limited by this provision, with public corporations paying, on average, an extra $2.5 billion per year in federal taxes. They continue, however, to deduct the majority of their executive compensation, with these deductions costing the U.S. Treasury an estimated $7.5 billion per year. Because actual tax return data are, by statute, confidential, our estimates are somewhat imprecise, as we have to infer both the tax deductibility of executive compensation and the corporation's tax status from public filings.

Our key findings are:

- Companies are allowed to fully deduct components of executive compensation that meet the IRS requirements to qualify as "performance-based." One of those requirements is shareholder approval. However, only very general information is provided to shareholders. Therefore, shareholders are asked to, and usually do, approve plans without knowing whether the performance conditions are challenging or not, and the potential payouts from the plan.
- Performance pay, such as stock options and non-equity incentive plans, that meets the IRS requirements for the "performance-based" exception is fully deductible. Salary, bonuses, and stock grants are deductible but subject to a limit of $1 million.
- In 2010 our estimate was that there was $27.8 billion of executive compensation that was deductible. A total of $121.5 billion in executive compensation was deductible over the 2007–2010 period. Roughly 55 percent of that total was for performance-based compensation.
- Seemingly tax-sophisticated corporations seem not to care about the restrictions on deductions and continue to pay nondeductible executive salaries. The number of executives receiving salary exceeding the maximum deductible threshold of $1 million actually increased from 563 in 2007 to 594 in 2010.
- For all that Section 162(m) is intended to limit excessive executive compensation, it is the shareholders and the U.S. Treasury who have suffered financial losses.
    - The code does not prohibit firms from paying any type of compensation; instead, they are prohibited from deducting that amount on their tax return. The result is decreased company profits and diminished returns to the shareholders.
    - Assuming a 25 percent marginal tax rate on corporate profits (a conservative estimate), revenue lost to the federal government in

2010 from deductible executive compensation was $7 billion, and the foregone federal revenue over the 2007–2010 period was $30.4 billion. More than half the foregone federal revenue is due to taxpayer subsidies for executive "performance pay."

- Executive compensation will likely recover in the near future, exceeding levels seen in 2007.

1. Background

Section 162 of the Internal Revenue Code covers trade and business expenses. As put forth in Section 162(a), entities are allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including, as noted in Section 162(a)(1), a reasonable allowance for salaries or other compensation for personal services actually rendered.

However, a number of sections of the Internal Revenue Code—in particular, sections 162(m), 162(m)(5), 162(m)(6), and 280(g)—limit the deductibility of executive compensation. Adopted in 1993, Section 162(m), which applies to publicly traded corporations, limits the deduction for executive compensation to $1 million per covered individual,[1] with an exception for qualified performance-based compensation. That is, a company can deduct $1 million of non-performance-based compensation per covered individual and an unlimited amount of performance-based compensation.

In contrast to Section 162(m), sections 162(m)(5) and 162(m)(6) are more recent and narrowly targeted; they apply, respectively, to Troubled Asset Relief Program (TARP) participants and health insurers. They also set a lower limit on the tax deductions allowed for compensation at $500,000 per individual, with no distinction or exception for performance-based compensation. Section 162(m)(5) was adopted in 2008 and applies to the chief executive officer (CEO), chief financial officer (CFO), and next three highest paid officers of public and private entities that accepted money under TARP. Section 162(m)(6) becomes effective in 2013, and its limitations apply to most employees of health care providers. Section 280(g) does not apply to periodic payments to employees, but rather to change in control payments.[2] If the amount is equal to or greater than three times the covered individual's average W-2 compensation for the prior five years, the company forfeits the tax deduction for that payment, and the individual is subject to a 20 percent excise tax on the excess payment. As with sections 162(m)(5) and 162(m)(6), Section 280(g) contains no performance-based exception.

To discuss the tax deductibility of executive compensation, this paper will focus on Section 162(m) because of its broader reach. Remember, it is not limited to a specific sector of the economy; it limits the deduction for executive compensation in public corporations to $1 million per covered individual, with an exception for qualified performance-based compensation. To qualify as performance-based compensation, the following requirements must be met:

1. The compensation must be paid solely on account of the executive's attainment of one or more performance goals determined by an objective formula. These goals can include stock price, market share, sales, costs or earnings, and can be applied to individuals, business units, or the corporation as a whole;
2. The performance goals must be established by a compensation committee of two or more independent directors;
3. The terms must be disclosed to shareholders and approved by a majority vote; and
4. The compensation committee must certify that the performance goals have been met before payment is made.

While Section 162(m) is intended to limit excessive executive compensation, this author sees several weaknesses or loopholes in the code. Regarding shareholder approval, companies need only give shareholders the most general terms when they put the compensation plan up for a

Components of the compensation package

Compensation component	TAX STATUS: Executive	TAX STATUS: Firm
Salary	Taxable	Deductible subject to $1 million cap
Bonuses	Taxable	Deductible subject to $1 million cap
Non-equity incentive plan	Taxable	Likely to be fully deductible
Stock grants	Taxable	Deductible subject to $1 million cap
Stock options	Taxable	Likely to be fully deductible
Stock appreciation rights	Taxable	Likely to be fully deductible
Pension and deferred compensation	Taxable	If deferred to after retirement likely to be fully deductible
Other compensation	Taxable	Deductible subject to $1 million cap

vote. Shareholders are asked to, and usually do, approve plans without knowing whether the performance conditions are challenging or not, and the potential payouts from the plan. Those details are left to the compensation committee, which must set the terms no later than the first quarter of the company's fiscal year. Also problematic is that if these terms are not met, the corporation is not prohibited from paying the compensation. Instead, it is prohibited from deducting that amount on its tax return. The result is decreased company profits. The ones who suffer are the shareholders—the same people who, even in this day of expanded compensation disclosures, are not provided with details on the executive compensation plans before being asked to vote on them, nor are they given information on the tax deductions taken or forfeited.

In Section 2, we will go through the components of the compensation package and discuss the tax consequences of each. Section 3 will utilize executive compensation information disclosed in corporate proxy statements—those required statements, useful in assessing how management is paid and identifying potential conflicts of interest, that must be filed with the U.S. Securities and Exchange Commission (Form DEF 14A)—to summarize and tabulate compensation reported for each year from 2007 to 2010 and to contrast the amounts reported with those actually deductible by those corporations. Section 4 will estimate the revenue loss associated with those deductions. The paper will conclude with Section 5, which will look back on the impact of these tax provisions, specifically the limitations on deductions and their effect on executive compensation, and look forward to how certain current events, such as the adoption of say-on-pay policies, will affect the future of executive compensation.

2. Components of the executive compensation package

Before we can fully explore the consequences of Section 162(m), we need to understand the executive compensation package. Hence, this section will introduce the components of the compensation package, which are summarized in the chart titled **"Components of the compensation package,"** and discuss their tax consequences to the executive and to the company.

Salary

Salary is the fixed, possibly contracted, amount of compensation that does not explicitly vary with performance. By definition, salary is not performance-based and therefore would not qualify for the performance-based exception under Section 162(m). Consequently it is taxable for the executive and deductible for the firm (subject to deduction limitations) in the year paid. It should be noted that the $1 million deduction limitation applies to all non-performance compensation in aggregate, not each individual component of that compensation. If a firm pays an executive salary of $750,000, the entire amount would be deductible. However, if it pays an additional $500,000 in other forms of non-performance compensation, its total deduction for non-performance-based compensation would be limited to $1 million; the additional $250,000 is not deductible.

Bonuses

Bonus compensation may be conditioned on the performance of an individual, group, or corporation. Because it is conditioned upon performance, it is often paid after the end of the company's fiscal year. From the employee's point of view it is taxable not in the year earned, but in the year received. For the employer, Treasury Regulation 1.404(b)-1T allows that a corporation using an accrual method of accounting can use the deduction in the year earned if an employee receives compensation within 2.5 months after the end of the employer's taxable year. In other words, bonuses are taxable to the executive in the year received, while deductible (subject to deduction limitations) in the year earned (under the assumption that bonuses are paid out within 2.5 months of year-end). Although bonuses are theoretically a reward for performance, they are not awarded or paid pursuant to a written plan approved by shareholders,[3] and therefore do not qualify as performance-based under Section 162(m).

Non-equity incentive plan compensation

Similar to bonuses, non-equity incentive plan compensation may be conditioned upon individual, group, or corporate performance. The difference between the two is that non-equity incentive plan compensation is paid under a written plan, which, for purposes of this study, we will assume meets the requirements of Section 162(m).[4] Consequently, payments under a non-equity incentive plan are fully taxable to the executive in the year received and deductible by the company in the year earned.[5]

Stock grants

Stock grants occur when corporations give shares to their employees.[6] They differ from stock options in that they have no exercise price. Whereas a stock option only has value if the corporation's share price is above the exercise price, a stock grant has value as long as the share price is above zero. Consequently, a stock grant is always worth more than a stock-option grant for the same number of shares. Stock grants can be unrestricted or restricted; however, the vast majority of employee grants are restricted. For example, a restriction might be that the executive cannot sell the shares until he or she has worked for the corporation for a period of time (a typical vesting period would be three or four years). Restrictions may also be based upon performance. For example, the executive will forfeit the shares if earnings and/or stock returns do not achieve a pre-established goal.[7] Once these restrictions expire, the executive has full ownership of the shares and, absent a Section 83(b) election,[8] will immediately recognize taxable income equivalent to the fair value of the stock at that time. Therefore, the year of grant and the year of tax recognition are usually different. The deductibility of the stock grants as performance-based depends on those restrictions. That is, if the restrictions are based upon performance, then the stock grants may qualify for the performance-based exception under Section 162(m),[9] whereas if the restrictions expire only with the passage of time, then they do not. In recent years there has been a trend to greater usage of what is now termed "per-

formance shares"; however, in previous years they were a distinct minority of stock grants. Consequently, the assumption made in this paper is that most of the grants made in earlier years and vesting in the observation period do not qualify for the Section 162(m) performance-based exception. The possibility is that as more grants become performance-based, the percentage and dollar amount of executive compensation that will be deductible will increase. Even performance-based stock grants, however, need not meet the requirements for deductibility. Consider the following passage from the 2012 Intel Corporation proxy statement:

> Section 162(m) of the tax code places a limit of $1 million on the amount of compensation that Intel may deduct in any one year with respect to its CEO and each of the next three most highly compensated executive officers (excluding the CFO). Certain performance-based compensation approved by stockholders is not subject to this deduction limit. Intel structured its 2006 Equity Incentive Plan with the intention that stock options awarded under the plan would qualify for tax deductibility. In addition, in order to maintain flexibility and promote simplicity in the administration of these arrangements, other compensation, such as OSUs, RSUs, and annual and semiannual incentive cash payments, are not designed to qualify for tax deductibility above the tax code Section 162(m) $1 million limitation.

The OSUs referred to in the above passage are outperformance stock units, i.e., performance-based, and yet are not designed to qualify under Section 162(m).

Stock options

Stock options allow their holder to purchase one or more shares of stock at a fixed exercise price over a fixed period of time. They have value if the corporation's share price at the time of exercise or purchase is greater than the exercise price. Since the exercise price is normally set at the share price on the date of grant, the ultimate value of the option depends upon the performance of a corporation's share price subsequent to the date of grant. That is, they can be extremely valuable when the share price rises dramatically, but can also expire worthless if the share price declines. Like stock grants, stock options are normally granted to executives with restrictions. These restrictions generally expire with the passage of time. While companies can add performance conditions to their stock options, currently that is rather infrequent. As with stock grants, the year of grant and year of tax recognition is normally different for stock options. They differ, however, in that stock grants are taxable upon expiration of the restrictions or vesting, whereas stock options are not taxable until the holder elects to exercise the options.[10] The amount that is taxable is not the fair value of the shares acquired, but the bargain element or discount, i.e., the difference between the fair value of the shares acquired less the exercise or purchase price paid. Stock options are considered performance-based under Section 162(m) if they meet minimal conditions (e.g., shareholder approval, options granted with an exercise price at or above market price on date of grant), the reasoning being that the option holder can only profit from the option if the share price increases. Thus the assumption made in this study is that stock option compensation is fully deductible to the firm.

Stock appreciation rights

While not as popular as stock options and grants, some companies grant stock appreciation rights (SARs). Stock appreciation rights are the right to receive the increase in the value of a specified number of shares of common stock over a defined period of time. Economically, they are equivalent to stock options, with one exception. With a stock option, the executive has to purchase and then sell the shares to receive his or her profit. With a stock appreciation right, the corporation simply pays the executive, in cash or common stock, the excess of the current market price of the shares over the exercise price. Thus the executive is able to realize the benefits of a stock option without having to purchase the stock. In many cases, stock appreciation rights are granted in tandem with stock options

where the executive, at the time of exercise, can choose either the stock option or stock appreciation right. For proxy-statement reporting purposes, SARs are combined with stock options. Similarly, they are treated like stock options for tax—including Section 162(m)—purposes. Consequently, for this analysis SARs will be incorporated into the broader category of stock options.

Pensions and deferred compensation

Deferred compensation is compensation that is earned in one period but deferred by the executive to be received in a future period. If it meets the requirements of Section 409(A) of the Internal Revenue Code, tax recognition may also be deferred until a future period. Pensions are a form of deferred compensation (covered by multiple separate sections of the Internal Revenue Code), whereby after retirement from the corporation, the employee receives a payment or series of payments. These payments may be defined by the pension plan (known as a defined benefit plan), or based upon the amounts accumulated in the employee's personal retirement account (known as a defined contribution plan, one type of which is a 401(k)). If the payments are defined by the pension plan they can be based upon a number of factors including, but not limited to, number of years with the corporation, earnings while working, and level within corporation. Pensions can be structured in many ways; for example, the payments can be fixed in amount, or they can be adjusted for inflation. Due to Internal Revenue Code limitations, executives are usually covered by more than one plan. That is, they participate in a primary "tax qualified" plan along with other employees, and have at least one "supplemental" non-qualified plan. The second plan is necessitated by Internal Revenue Code limitations on payments from a qualified plan. That is, in order to qualify for favorable tax treatment, the plan must be nondiscriminatory, that is, the benefits cannot be skewed in favor of highly paid employees, and the corporation cannot consider compensation in excess of a threshold, which was $250,000 for the year 2012 (Section 401(a)(17)), in determining pension benefits, nor make payments in excess of $200,000 (Section 415(b)). Most top executives make substantially larger sums.

For tax purposes, both defined benefit and defined contribution plans are divided into qualified and non-qualified plans. With a qualified plan, the company can contribute or fund it currently, and take the corresponding tax deductions (above and beyond the Section 162(m) limitations), while the executive does not recognize taxable income until the future when he or she receives the payments. However, given the limitations discussed above, companies turn to non-qualified or supplemental executive retirement plans (SERPs) for the bulk of retirement payments to their executives. Because these plans are not qualified, they are unfunded, as funding would subject the executive to current taxation.

To sum up, the bulk of pension and deferred-compensation payments are both taxable and deductible after retirement, at which point they are no longer disclosed in the corporate proxy statement. At that time, they will be fully deductible, as the then-retired executive will no longer be subject to Section 162(m). Thus, while the next section will discuss the amounts reported as increases in pensions and deferred compensation in the proxy statement, it will not incorporate any of those amounts when estimating the immediate tax consequences of executive compensation.[11]

All other compensation

The proxy statement summary compensation table contains one other category, a catch-all category that encompasses everything not included in the prior headings: "all other compensation." All other compensation includes items such as those infamous perquisites; e.g., private airplanes, company cars, etc. For purposes of this paper, we assume that the amounts reported as "all other compensation" in the proxy statement are currently taxable to the executive and deductible by the company, subject to Section 162(m) limitations, as they are not performance-based.

Caveat

In the above summary chart, "Components of the compensation package," we use the phrase "likely to be fully deductible" for a reason. As outsiders, drawing data from a large-scale database, we cannot determine precisely what is and what is not deductible. Note from above that performance-based compensation can qualify for full deductibility if the company meets the requirements set forth in the Internal Revenue Code. However, sometimes companies choose not to comply with those requirements. Consider the following excerpt from Goodyear Tire & Rubber Company's most recent proxy statement:

> Tax Deductibility of Pay
>
> Section 162(m) of the Code provides that compensation paid to a public company's chief executive officer and its three other highest paid executive officers at the end of the year (other than its chief financial officer) in excess of $1 million is not deductible unless certain requirements have been satisfied. The Compensation Committee believes that awards under the Management Incentive Plan and the 2008 Performance Plan qualify for full deductibility under Section 162(m).
>
> Although compensation paid under the Executive Performance Plan is performance-based, it does not qualify for the deductibility exception for performance-based compensation since that Plan has not been approved by our shareholders. Therefore, payments under the Executive Performance Plan are subject to the Section 162(m) limitation on deductibility. Because of our significant U.S. deferred tax assets from prior periods, the limitation on deductibility has no impact on our financial position. In reviewing and considering payouts or earnings under the Executive Performance Plan, the Compensation Committee considered not only the impact of the lost tax deductions, but also the significant U.S. deferred tax assets available to us from prior periods, as well as the benefits realized by us and our shareholders from the successful efforts of our senior management team. In balancing these considerations, the Compensation Committee concluded that it would be appropriate to approve payouts in respect of the 2009-2011 grants and earnings for the 2011 performance period in respect of the 2010-2012 and 2011-2013 grants.

Without reading this passage we would have assumed that compensation paid under the Executive Performance Plan, which will be reported as non-equity incentive plan compensation, would be fully deductible. A further complication is that payments under both the Management Incentive Plan, which does qualify for the performance-based exception, and the Executive Performance Plan, which does not, are reported in the proxy statement summary compensation table as one number under the non-equity incentive column. And while Goodyear is to be commended for the clarity of its disclosure, most disclosures are not that clear.

3. Executive compensation, 2007–2010

This section provides an analysis and discussion of executive compensation paid over 2007–2010. As shown in **Table 1**, the sample is the population of U.S. public corporations as included in the Standard & Poor's Capital IQ database and ranges from 8,960 in 2007 to 7,248 in 2010.[12] Under current Securities and Exchange Commission regulations, companies are required to report in their proxy statements the compensation of each and every individual who has held either the CEO or CFO title during the year, compensation of the next three highest paid individuals,[13] and compensation of up to two additional individuals who would have been among the next three highest paid individuals except that they were no longer employed at the end of the year. Reporting is not required if an individual's compensation is less than $100,000. Turning to the second column of Table 1, we see that

TABLE 1

Sample information

	Number of companies	Number of executives	Number of CEOs	Number of non-CEO executives
2007	8,960	38,824	8,849	29,975
2008	8,392	35,485	8,240	27,245
2009	7,892	32,367	7,832	24,535
2010	7,248	28,365	7,217	21,148
Total	**32,492**	**135,041**	**32,138**	**102,903**

Source: Author's analysis of Capital IQ microdata

the number of executives included in the analysis ranges from 38,824 in 2007 to 28,365 in 2010.[14] While Section 162(m) limitations only apply to the compensation of the CEO and the next three highest paid individuals, excluding the CFO, Capital IQ and consequently we, include compensation of all executives included in the proxy statement. For executives beyond the CEO and the next three highest paid individuals we assume that compensation is fully deductible.

Table 2 describes the various components of the compensation package for 2007–2010, and lists the number of individuals receiving the item in a given year.[15] For example, all executives in our sample receive a salary (companies with missing salary data are excluded from the analysis), but not all receive bonuses, and even fewer receive non-equity incentives and other forms of compensation. The mean total compensation was highest in 2007, at just over $1.7 million. The ensuing decrease in average compensation is due to the sharp drop in stock prices, which diminished the value of stock grants. The mean compensation values in this table are lower than those normally observed in the press and most studies for two reasons. The first is that most studies limit themselves to CEO compensation, whereas this study expands the sample to all executives. Because other executives are normally paid less than the CEO, this drives the average down. For example, in 2007 average total compensation for CEOs was $3,468,375, while the average for non-CEOs was $1,191,828. The second reason for lower means is the broader sample of companies used in this study. Most studies limit themselves to the S&P 500 or the S&P 1500 companies as encompassed in Standard & Poor's ExecuComp, whereas this study incorporates those companies and many smaller publicly traded companies. Because compensation tends to increase with firm size, inclusion of these smaller companies reduces our averages. For example, in 2007 the average total compensation for executives in S&P 500 companies was $4,994,819, while the average for other companies was $1,448,167.

Table 3 aggregates the amounts reported in Table 2 to illustrate the total of executive compensation for all publicly traded companies. Aggregate total compensation decreased from over $66 billion in 2007 to $42 billion in 2010. There are two reasons for this decrease. First, the number of companies/executives incorporated in our analysis decreased in 2010 (as shown in Table 1 and reflecting the decline in the number of publicly traded companies). Second, average compensation (as shown in Table 2) decreased as well.

As discussed in Section 2, the year of taxability for equity compensation, i.e., stock grants and stock options, differs

TABLE 2

Mean amounts for executive compensation reported in summary compensation table (dollars; number of executives are below mean amounts)

	Salaries	Bonuses	Non-equity incentives	Stock grants	Stock option grants	Pensions and deferred compensation	All other compensation	Total compensation
2007	$272,523	$123,484	$284,730	$1,182,867	$326,993	$139,393	$134,324	$1,710,712
	38,511	25,571	22,790	25,329	28,775	14,745	35,016	38,824
2008	$285,374	$87,385	$225,486	$414,213	$310,514	$124,054	$88,712	$1,191,943
	35,225	26,167	23,296	26,541	28,028	15,773	33,453	35,485
2009	$293,984	$81,083	$235,515	$364,247	$255,065	$145,494	$82,236	$1,169,813
	32,257	25,873	22,988	25,418	26,347	15,478	31,137	32,367
2010	$317,646	$103,843	$346,259	$520,141	$305,198	$165,168	$97,044	$1,479,961
	28,279	22,837	20,381	22,273	23,063	13,480	27,319	28,365

Source: Author's analysis of Capital IQ microdata

TABLE 3

Aggregate amounts for executive compensation reported in summary compensation table (billions of dollars; number of executives are below aggregate amounts)

	Salaries	Bonuses	Non-equity incentives	Stock grants	Stock option grants	Pensions and deferred compensation	All other compensation	Total compensation
2007	$10.5	$3.2	$6.5	$30.0	$9.4	$2.1	$4.7	$66.4
	38,511	25,571	22,790	25,329	28,775	14,745	35,016	38,824
2008	$10.1	$2.3	$5.3	$11.0	$8.7	$2.0	$3.0	$42.3
	35,225	26,167	23,296	26,541	28,028	15,773	33,453	35,485
2009	$9.5	$2.1	$5.4	$9.3	$6.7	$2.3	$2.6	$37.9
	32,257	25,873	22,988	25,418	26,347	15,478	31,137	32,367
2010	$9.0	$2.4	$7.1	$11.6	$7.0	$2.2	$2.7	$42.0
	28,279	22,837	20,381	22,273	23,063	13,480	27,319	28,365

Source: Author's analysis of Capital IQ microdata

from the year of grant. Similarly, the amounts will differ from that reported in the year of grant, as the amount reported in the year of grant will be based upon an expected amount, while that included in the executives' income/deducted from the companies' taxable income will be based on the actual amount. The amounts reported in tables 2 and 3 are grant date values based upon amounts from the proxy statement summary compensa-

TABLE 4

Amounts reported for vested shares and exercised options (number of executives are below dollar amounts)

	Mean dollar value of shares vested (dollars)	Mean dollar profit in options exercised (dollars)	Aggregate dollar value of shares vested (billions of dollars)	Aggregate dollar profit in options exercised (billions of dollars)
2007	$557,064	$1,059,619	$9.0	$17.4
	16,080	16,428	16,080	16,428
2008	$541,980	$722,580	$9.2	$11.7
	16,894	16,208	16,894	16,208
2009	$358,816	$271,415	$6.5	$5.2
	18,124	19,005	18,124	19,005
2010	$548,318	$414,884	$9.7	$7.9
	17,711	19,096	17,711	19,096

Source: Author's analysis of Capital IQ microdata

tion table. In contrast, the amounts in **Table 4** are based upon the vesting date value of stock grants and exercise date profits for stock options, as reported by companies in their proxy statements. Looking at the mean amounts, we are somewhat surprised to see that the number of employees with stock grants vesting (Table 4) is significantly less than the number receiving stock grants (Table 2). A number of potential explanations for this exist, such as stock grants vesting after retirement or stock grants not vesting because restrictions were not met. Unfortunately, the data do not allow us to determine what these reasons are. Similarly, for stock grants the aggregate amount recognized for tax purposes in Table 4 is less than the amount reported in Table 3, although the taxable amounts for stock options are generally greater than that reported in the summary compensation table.

Table 5 focuses on the impact of Section 162(m) on the deductibility of non-performance-based compensation, which is defined as salary, bonus, stock grants, and all other compensation. As noted above, although the bonus is normally performance-based, if it is not paid pursuant to a written plan that meets Internal Revenue Code requirements, it will not qualify for the performance-based exception (and if it were paid pursuant to a written plan, it should be included in the non-equity incentive column). Stock grants with performance conditions have become more common, and therefore may qualify for the Section 162(m) performance-based exception,[16] but constitute a minority of those stock grants that vested during the years 2007 through 2010. Consequently we sum these four items—salary, bonus, stock grants, and all other compensation—by individual and treat the first $1 million as deductible.

We shift gears in **Table 6** to examine the total deductions associated with executive compensation, performance and non-performance based. On an aggregate basis the deductible components of the compensation package decline from about $39 billion in 2007 to a little less than $28 billion in 2010, with much of the decrease being associated with fewer deductions associated with stock options. In 2010 $15 billion of the deductions were based on performance pay, down from roughly $24 bil-

TABLE 5

Decomposition of non-performance-based compensation into deductible and nondeductible amounts (billions of dollars)

	AGGREGATE DOLLAR VALUES					AGGREGATE	
	Salaries	Bonuses	Vested shares	All other compensation	Total taxable amount to executives	Deductible	Nondeductible
2007	$10.5	$3.2	$9.0	$4.7	$27.3	$15.1	$12.2
2008	10.1	2.3	9.2	3.0	24.5	14.1	10.4
2009	9.5	2.1	6.5	2.6	20.6	13.0	7.6
2010	9.0	2.4	9.7	2.7	23.7	12.9	10.9

Source: Author's analysis of Capital IQ microdata

TABLE 6

Total deductible compensation (billions of dollars)

	2007	2008	2009	2010	2007–2010
Number of executives	38,511	35,225	32,257	28,279	
Non-performance-based	$15.1	$14.1	$13.0	$12.9	$55.1
Performance-based compensation	23.9	17.0	10.6	15.0	66.4
Non-equity incentives	6.5	5.3	5.4	7.1	24.2
Aggregate dollar profit in options exercised	17.4	11.7	5.2	7.9	42.2
Total deductible	**39.0**	**31.0**	**23.6**	**27.8**	**121.5**

Source: Author's analysis of Capital IQ microdata

lion in 2007. As discussed in the next section, even at these reduced amounts in 2010 there are substantial tax savings for the companies and revenue foregone to the federal government. The **Appendix Table** provides more detail underlying the aggregates in Table 6 by delineating the total deductions for CEOs and other executives and doing so for large firms (S&P 500) and other firms.

Compensation, taxation, and deductibility: An illustration

At this point an illustration comparing the amounts reported in the proxy statement summary compensation table, executive's tax return, and corporation's tax return might be informative. Consider the 2011 compensation of Paul S. Otellini, president and CEO of Intel. According to the proxy statement summary compensation table, he received total compensation of $17,491,900 for that year.

Of that amount, stock awards ($7,331,100), option awards ($1,802,800), and change in deferred compensation ($319,000) are not taxable currently. His taxable income from Intel will include a salary ($1,100,000), a bonus ($34,000), non-equity incentive plan income ($6,429,500), all other compensation ($475,500), stock grants that vested during the year ($1,319,600), and exercised stock options ($132,100). His total taxable income was therefore $9,490,700.

The amount currently deductible by Intel includes both non-performance compensation and compensation that qualifies for the performance-based exception. Non-performance compensation includes the salary ($1,100,000), bonus ($34,000), all other compensation ($475,500), and stock grants that vested during the year ($1,319,600), for a total of $2,929,100. With the $1 million cap on deductions, Intel forfeits deductions on $1,929,100 of CEO compensation. At the same time, it can deduct for non-performance-based compensation (the maximum allowable at $1 million), non-equity incentive plan income ($6,429,500), and the exercised stock options ($132,100), for a total deduction of $7,561,600—an amount much less than Mr. Otellini's $9,490,700 in taxable income.

Mr. Otellini and Intel provide a perfect illustration of the aggregate numbers in Table 5. What is most interesting, to this author, about Table 5 is the magnitude of deductions being forfeited by public corporations for the sake of executive compensation. Over the four-year period examined, executives recognized $96 billion in taxable income from the four categories of salary, bonus, vest value of stock grants, and all other compensation, while companies only deducted $55 billion, forfeiting slightly more than $41 billion in potential deductions!

Hence, one of the problems with Section 162(m), which was adopted ostensibly to reduce excessive, non-performance-based compensation (see U.S. House of Representatives 1993), was that it never touched on compensation directly. Instead, it legislated the deductibility of that compensation and penalized shareholders rather than executives. While corporations have "paid lip service" to the idea of preserving deductions, empirical research has shown only a marginal effect on executive compensation.[17] Overall, however, executive compensation has continued to grow, and with it deductions have been forfeited.[18] For example, the number of executives receiving salary in excess of $1 million increased from 563 in 2007 to 594 in 2010, and the number of executives receiving non-performance-based compensation in excess of $1 million increased from 3,379 in 2007 to 4,729 in 2010. This is despite a substantial decrease in the number of executives covered from 2007 to 2010 (see Table 1). Seemingly tax-sophisticated corporations seem not to care about the restrictions on deductions.

Consider Apple Inc. Duhigg and Kocieniewski (2012) detail how Apple avoids billions in taxes by setting up subsidiaries in low-tax jurisdictions. Yet when Apple made Tim Cook their CEO in August 2011, they gave him one million shares of restricted stock that vested purely with the passage of time, which therefore is not performance-based. Consequently, this grant, valued at $378 million at the time it was made, would not meet the performance-based exception of Section 162(m) and therefore would not be deductible—costing shareholders more than $100 million in additional taxes!

4. Tax benefits to corporations

As noted above, compensation is normally deductible as an ordinary business expense under Section 162 of the Internal Revenue Code. This benefit can be large for the corporation and costly for the federal Treasury,[19] as the corporate tax rate is 15 percent for taxable incomes under $50,000, 25 percent for those between $50,000 and $75,000, 34 percent for those between $75,000 and $100,000, 39 percent for those between $100,000 and $333,333, and 34 percent for taxable incomes between $333,333 and $10 million.[20] Above $10 million, the rate increases to 35 percent (except between $15,000,000 and $18,333,333, where the tax rate is 38 percent). A reas-

onable assumption is that most public corporations have taxable incomes in excess of $100,000, so their tax rate would either be 34 or 35 percent.

For a number of reasons, such as tax deductions and credits, even large public corporations may pay taxes at a lower rate, or not at all—thus the tax benefit of executive compensation can be overstated. An example is Whirlpool Corporation, which, due to tax credits, did not pay taxes in 2010 and 2011. Whirlpool is not alone in this regard (for example, see the Goodyear excerpt above). So the question becomes: What is the value of the tax deductions associated with executive compensation to companies like Whirlpool? Note that if the corporation has a tax loss, as in the case of Whirlpool, it can use that loss to claim a refund on taxes paid in the previous two years or to shelter taxable income earned in the following 20 years. In theory, even if the company does not have any current taxable income, a $1 additional deduction will either increase this year's tax refund by 35 cents, or reduce future taxes by 35 cents. But in practice, sometimes a company can't claim the carryback because it hasn't paid federal taxes in the past two years, and the existence of taxable income in the future may be uncertain as well. If so, how do we estimate the benefits of these deductions?

Academic researchers answer this question by estimating marginal tax rates, the rate of tax/benefit associated with the next dollar of income/deduction. Professor John Graham of Duke University, who has done extensive research in the area (see Graham 1996), provides estimates of these rates on his website, http://faculty.fuqua.duke.edu/~jgraham/taxform.html. Unfortunately, he does not provide tax rates for all companies in the Capital IQ data set. But for the approximately 25 percent of observations for which he does provide tax rates, the rates he provides are substantially lower than 35 percent, as the mean of his rates is slightly below 13 percent. As an alternative, in another paper (Graham and Mills 2008) he provides a fairly simple and less data-intensive method of calculating marginal tax rates. Using that algorithm still results in a sample reduction of about 30 percent, but perhaps a more realistic average tax rate of 25 percent. However, both rates are calculated after the impact of executive compensation, and Graham, Lang, and Shackelford (2004), among others, document that the stock-option deduction can significantly decrease marginal tax rates. So when calculating the average tax benefit of the executive compensation deductions, the relevant tax rate to use is something lower than 35 percent, yet is somewhat higher, perhaps significantly higher, than 13 or 25 percent. For this reason, **Table 7** provides estimates using three alternative rates—15, 25, and 35 percent—while the following discussion uses what is probably the most realistic estimate, 25 percent.

Table 7 provides some boundaries for the aggregate tax savings to companies and costs to the Treasury using effective tax rates of 15, 25, and 35 percent. Using the 15 percent rate provides the lower bound on our estimate of the tax savings, which ranges from about $3.5 billion in 2009 to just under $6 billion in 2007. In contrast, using the 35 percent statutory federal rate provides an upper bound on our estimate of the aggregate tax benefits/cost to the U.S. Treasury, which ranges from about $13.7 billion in 2007 to $8.3 billion in 2009. If we assume a conservatively estimated 25 percent marginal tax rate, then revenue lost to the federal government in 2010 from deductible executive compensation was about $7 billion, and the total amount lost over the 2007–2010 period was $30.4 billion.

5. Looking back and forward

While the data provided in this study do show a moderating of executive compensation over the study period 2007–2010, over a longer period it is well known that executive, in particular CEO, compensation has increased at rates far in excess of inflation and the wage growth of rank-and-file individuals. So the question exists: Is the moderating trend observed over the recent past a new paradigm, or is it merely one of the outcomes of the country's severe financial crisis?

TABLE 7

Estimated tax savings/revenue loss as a result of executive compensation (billions of dollars)

	Total deductions	Tax savings at 15% rate	Tax savings at 25% rate	Tax savings at 35% rate
2007	$39.0	$5.9	$9.8	$13.7
2008	31.0	4.7	7.8	10.9
2009	23.6	3.5	5.9	8.3
2010	27.8	4.2	7.0	9.7
2007–2010	**121.5**	**18.2**	**30.4**	**42.5**

Source: Author's analysis of Capital IQ microdata

In terms of a new paradigm, 2010 marked a once-in-a-lifetime opportunity for shareholder empowerment. That July, the Dodd-Frank banking bill imposed the long-awaited "say-on-pay" on American corporations, which took effect with annual meetings on or after January 21, 2011. This provision, which was widely opposed by the business community, requires that publicly traded corporations provide their shareholders with a non-binding vote on their executive compensation at least once every three years. While the vote is (1) after the fact, i.e., shareholders are voting to approve compensation provided in the previous year, and (2) advisory, the possibility does exist that the board will moderate compensation to avoid being embarrassed by a negative outcome.[21] In fact, Lucien Bebchuk of Harvard University notes in several of his papers that shame is perhaps the only constraint on executive compensation. Academic research in the United Kingdom, where say-on-pay has been in effect since 2002, and in the United States, by this author, suggests that say-on-pay can have a restraining impact on executive compensation under certain circumstances.

Another provision of the Dodd-Frank banking bill, which has not yet been implemented by the Securities and Exchange Commission, is the requirement that companies disclose the ratio of CEO compensation to that of the company's median employee. This disclosure, which has been opposed by companies, also has the potential to embarrass corporate boards and CEOs, and if put into place, has the potential to restrain executive compensation.[22]

But looking back, a reasonable question might be whether mandatory disclosure and tax penalties have worked to restrain compensation. In this author's lifetime, the first big change in proxy statement disclosure was made in 1993. This disclosure, which dramatically increased the amount disclosed, inadvertently led to increased compensation, as executives at one company were able to more clearly assess what executives at their competitors were making. Section 280(g) of the Internal Revenue Code caused companies to forfeit deductions and imposed penalties on the recipient, if change-in-control payments (i.e., "golden parachutes") were higher than allowed by the section. This Internal Revenue Code section did little, if anything, to curtail those payments, as companies without change-in-control payments added them, while those with change-in-control payments in excess of that allowed added the now-infamous tax gross-ups, whereby the shareholders would provide additional compensation to pay the executive's tax penalty as well as the tax on that additional compensation. The same

holds true for Section 162(m). Harris and Livingstone (2002) suggest that inadvertently, Section 162(m) may have encouraged increases in cash compensation for executives earning less than $1 million. Balsam and Ryan (2008) find that Section 162(m) resulted in increases in stock option compensation for executives earning more than $1 million in cash compensation. And although stock options were in favor amongst the political class when Section 162(m) was adopted, by the time the 21st century rolled around, the shine had worn off. In discussing the effect of Section 162(m) on the increased use of stock options, a 2006 *Wall Street Journal* article (Maremont and Forelle 2006) quoted Christopher Cox, the then-chairman of the Securities and Exchange Commission, as saying it deserves a "place in the museum of unintended consequences."

The belief of this author is that executive compensation will recover in the near future, exceeding levels seen in 2007. Some of that increase will be in the form of deductible performance-based compensation, but the level of non-performance-based compensation will increase as well.

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Endnotes

1. Covered individuals were originally defined as the chief executive officer plus the next four highest paid executive officers, as disclosed in the corporate proxy statement. However, in late 2006 the Securities and Exchange Commission changed the proxy statement disclosure requirements, so that corporations had to disclose compensation for the chief executive officer, chief financial officer, and next three highest paid executive officers. Since Section 162(m) does not specify the chief financial officer, covered individuals are now the chief executive officer plus the next three highest paid executive officers.

2. A change in control payment, also known as a golden parachute, is a payment to an executive that occurs when his or her company experiences a change in ownership.

3. For purposes of proxy statement reporting, awards pursuant to a written plan have been incorporated under the heading of "non-equity incentive plan compensation" since the end of 2006. It is common to combine the two categories of bonus and non-equity incentive plan compensation for other purposes.

4. This may not always be the case; even when there is a written plan, the plan may not meet Section 162(m) requirements. In a private letter ruling (http://www.irs.gov/pub/irs-wd/0804004.pdf) the IRS informed the company in question that compensation paid under its incentive plan would not qualify as performance-based, because the plan allowed for payments in the event of termination regardless of whether the performance conditions were met.

5. When the compensation is earned over a multiple year period, e.g., a two- or three-year performance period, the deduction would be taken in the last year of the period.

6. Sometimes rather than granting shares, companies grant units, which are then turned into shares upon vesting.

7. In most cases, meeting performance conditions is not a yes/no proposition. Typically, the percentage of shares that vest vary based upon performance, with a lesser number of shares vesting if performance meets the pre-established minimum threshold, the full grant vesting if performance meets the pre-established target, and possibly additional

shares being earned if performance exceeds the target, up to a maximum that is usually defined as 200 percent of the original grant.

8. Normally a stock grant is not taxable to the recipient or deductible by the grantor until the restrictions expire. However, under tax code Section 83(b) the recipient may elect to have the grant taxed at the time of grant. Discussions with practitioners confirm these elections are rare in public companies.

9. Companies do not always clearly disclose whether their compensation qualifies as performance-based, nor do they disclose the amounts of deductions forfeited.

10. This discussion ignores Section 422 (tax-qualified or incentive) stock options. A Section 422 stock option provides benefits to its holder, as the tax event is not exercised, but rather the later sale of the shares is acquired upon exercise. Further, if certain conditions are met (for example, the shares are held from two years from the date of grant to one year from the date of exercise), the income is taxed as a capital gain and not ordinary income. While these options are beneficial to their holder, they are costly to the company, because if the holder meets the conditions for capital gain treatment, the company does not receive any tax deduction. However, because these options are limited to $100,000 in nominal value vesting per year and are considered tax-preference items at the time of exercise for purposes of the alternative minimum tax, they are not very useful (or used) in executive compensation. Thus we can safely ignore them in our discussion.

11. While pensions and deferred compensation need to be recognized as financial accounting expenses and disclosed in proxy statements in the year earned, for tax purposes they receive deferred recognition. Consequently, if deferred until the executive is no longer covered by Section 162(m) (e.g., post-retirement), they will be fully deductible for tax purposes.

12. This decrease is consistent with the decrease in publicly traded companies as documented in Stuart (2011). See http://www.cfo.com/article.cfm/14563859.

13. Since 2007, the Section 162(m) limitations only apply to the compensation of the CEO and the next three highest paid individuals.

14. In theory, each company should have a CEO, but not all companies identify an individual as such in their filings. Consequently, the number of CEOs is slightly less than the number of companies in each year.

15. Capital IQ collects and we analyze the values as reported by companies in their proxy statements.

16. But do not have to, as illustrated by the excerpt from the Intel proxy statement above.

17. For example, Balsam and Ryan (2007) show that Section 162(m) increased the performance sensitivity of bonus payments for CEOs hired post-1994.

18. For more discussion on the forfeiture of deductions, see Balsam and Yin (2005).

19. This analysis only incorporates federal taxes. Incorporating state income taxes would increase the benefit associated with compensation deductions.

20. The 39 percent tax rate is intended to remove the benefits associated with the 15 percent and 25 percent rates.

21. In the first two years of say-on-pay, more than 98 percent of companies have had their executive compensation approved by shareholders, with the typical firm receiving a positive vote in excess of 80 percent. However, some well-known companies have had their executive compensation rejected by shareholders, including Hewlett-Packard in 2011 and Citigroup in 2012.

22. While the disclosure only applies to CEO compensation, compensation of other executives is often tied to that of the CEO.

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APPENDIX TABLE 1

Total deductible compensation (billions of dollars)

	Non-performance-based	PERFORMANCE-BASED COMPENSATION			Total deductible
		Non-equity incentives	Aggregate dollar profit in options exercised	Total performance-based compensation	
Total					
2007	$15.1	$6.5	$17.4	$23.9	$39.0
2008	14.1	5.3	11.7	17.0	31.0
2009	13.0	5.4	5.2	10.6	23.6
2010	12.9	7.1	7.9	15.0	27.8
2007–2010	55.1	24.2	42.2	66.4	121.5
CEOs, large firms (S&P 500)					
2007	$0.5	$0.9	$3.0	$3.9	$4.4
2008	0.5	0.9	4.3	5.1	5.6
2009	0.5	0.9	1.3	2.1	2.6
2010	0.5	1.1	1.7	2.8	3.3
2007–2010	1.9	3.8	10.2	14.0	15.9
Other executives, large firms					
2007	$1.8	$1.5	$4.6	$6.2	$8.0
2008	1.9	1.3	2.7	4.0	5.8
2009	1.8	1.3	1.1	2.4	4.2
2010	1.8	1.6	1.9	3.6	5.4
2007–2010	7.3	5.7	10.4	16.1	23.4
CEOs, other firms (non S&P 500)					
2007	$3.5	$1.5	$4.0	$5.5	$9.0
2008	3.2	1.2	2.2	3.3	6.6
2009	3.1	1.3	1.3	2.6	5.7
2010	3.1	1.7	1.8	3.5	6.6
2007–2010	12.9	5.7	9.3	15.0	27.9
Other executives, other firms					
2007	$9.3	$2.5	$5.8	$8.3	$17.6

APPENDIX TABLE 1 (CONTINUED)

	Non-per-formance-based	PERFORMANCE-BASED COMPENSATION			Total deductible
		Non-equity incentives	Aggregate dollar profit in options exercised	Total performance-based compensation	
2008	8.5	1.9	2.6	4.5	13.1
2009	7.6	2.0	1.5	3.5	11.1
2010	7.5	2.6	2.5	5.1	12.5
2007–2010	33.0	9.0	12.3	21.3	54.3

Source: Author's analysis of Capital IQ microdata