Center On Executive Compensation

Policy Brief

Senate Bill Would Cap Company Deductions on Executive, Employee Pay at $1 Million

S. 1476, the "Stop Subsidizing Multimillion Dollar Corporate Bonuses Act" by Senators Reed and Blumenthal Targets Tax Code Section 162(m)

In anticipation of future debates on the budget and comprehensive tax reform, legislation recently introduced by Senators Jack Reed (D-RI) and Richard Blumenthal (D-CT) would put a flat $1 million limit on compensation deductions for all current and former employees and eliminate exceptions for performance-based pay. The bill would expand considerably the current $1 million limitation on compensation deductions for the CEO and the three other most highly paid executives (other than the CFO), which includes exceptions for performance-based compensation. In introducing the bill, the sponsors sought to reframe deductions for compensation which are currently considered "ordinary, necessary and reasonable" business expenses to a "performance-based corporate tax loophole" in which American taxpayers are "subsidizing multimillion dollar corporate bonuses." In introducing the bill, Senator Reed argued that it "will restore fairness to the tax code and ensure corporations, not taxpayers, are the ones who pay for multi-million dollar bonuses." Senator Blumenthal added, "We should be investing in working families, not using taxpayer dollars for tax breaks to corporations that overpay their executives." As discussed in the following analysis, the legislation would effectively represent a corporate tax increase and shift the cost of a reasonable business expense for attracting, retaining and motivating top talent to the shareholders of corporations while at the same time raising the effective corporate tax rate for American companies that is already on average 7.6% higher than other large countries.

Section 162(m) Was Intended to Limit Senior Executive Compensation, Encourage Performance-Based Pay Section 162(m) limits the ability of a company to take a deduction for the compensation of the company's CEO and three other most highly compensated employees other than the CFO to $1 million annually. There are several exceptions, however, with the most notable exception allowing companies to deduct compensation exceeding the $1 million limit if the compensation is performance or commission-based. To be considered performance-based, the performance goals must be determined by a compensation committee comprised of two or more independent directors, the material terms of the performance-based compensation program must be approved at least every five years by shareholders, and the compensation committee must certify that the performance goals and other material terms were achieved before the incentives are paid. In passing section 162(m), Congress mandated that stock options be considered *per se* performance-based. Most corporations seek to make the majority of incentive plan payments deductible as performance-based compensation to be as tax efficient for their shareholders as possible. The concept behind section 162(m) was championed by Presidential-candidate Bill Clinton in 1992 as a way to limit executive compensation and make it more performance-based. As with many ideas that sound good in theory, in practice, the provision has served to make $1 million a de facto compensation floor for CEOs and has been criticized by Democrats and Republicans alike, with former SEC Chair Christopher Cox stating that it belonged "in the museum of unintended consequences." Limits on Section 162(m) deductions were included in the TARP and post-meltdown stimulus statutes, and the most substantial were included in the Affordable Care Act, which included a $500,000 limitation on company deductions for all employees of certain health insurance carriers.

S.1476 Unsurprising After Aggressive Push to Reframe Impact of Deductions for Executive Compensation With rumors circulating that the Senate will use a "clean slate" approach in enacting major tax reform where proponents will have to lobby to get deductions added into the otherwise blank revamped tax code, there has been concerted effort to limit the deductions for performance-based pay for senior executives under 162(m). In the past several months there have been renewed calls for the limitation of 162(m) in white papers and pundit commentary. A widely circulated article by former

Secretary of Labor Robert Reich criticized §162(m) as creating a "pay for performance loophole" allowing executives to be awarded "performance awards based on nothing more than an upward drift in stock price." Around the same time, progressive advocacy group the Roosevelt Institute released a study arguing that §162(m) amounted "to a structural change in how executives are paid," and that all performance-based exceptions should be eliminated. Likewise, the Institute for Policy Studies issued a report in May which characterized 162(m) as allowing CEOs to "rak[e] in huge taxpayer-funded bonuses at the same time they are insisting on deep cuts in the government programs that benefit ordinary Americans." Income inequality has always been a rallying point for Democrats and President Obama. However, as demonstrated above, income inequality has become the preferred point of rhetoric for discussing economic and tax policy issues and has received heightened focus and media coverage mischaracterizing it as providing companies with a corporate tax loophole which forces taxpayers to "subsidize excessive executive compensation" thereby exacerbating the country's income inequality problems.

The Changes to 162(m) Would Increase Corporate Tax Liabilities at a Time When U.S. Corporate Taxes Exceed Those of Most Developed Countries The U.S. has the world's highest marginal tax rate at 35% and an effective tax rate that is on average 7.6% higher than other large countries. Yet, S. 1476 makes three primary changes to Section 162(m) of the Internal Revenue Code that would increase taxes on corporations:

- <u>Broadens the Applicability of 162(m) to All "Current and Former Employees."</u> Under current law, section 162(m) only imposes the $1 million deduction limit on the compensation expenses of a company's CEO and three other highest compensated individuals. Companies are otherwise free to deduct compensation expenses paid to other employees as long as the deductions comply with the Internal Revenue Code. S. 1476, however, would expand 162(m)'s deduction limit from the small pool of current executives to "all current and former employees." Thus, it would affect non-qualified deferred compensation as well as current compensation.
- <u>Eliminates the Exceptions for Performance-based and Commission-based Compensation</u>. As section 162(m) is currently written, compensation paid to executives in excess of the $1 million cap can be deducted if it is performance or commission-based. S. 1476 removes this exception to section 162(m) imposing a hard cap for employee compensation deductions at $1 million, with no exceptions.
- <u>Expands the Companies to which Section 162(m) Applies</u>. As currently written, section 162(m) only applies to public companies with a class of stock on a national stock exchange. However, S. 1476 expands section 162(m)'s application to apply to all companies which have registered with the SEC and are filing periodic reports even if they do not have a class of shares listed on a stock exchange.

Together, the changes to section 162(m) included in S. 1476 would limit a larger number of companies to a $1 million dollar deduction for employee compensation expenses per employee in a taxable year for all current and former employees, with no exceptions. Consider the following implications for companies and individuals:

1. <u>The hard cap of $1 million on deductible compensation by companies will reduce net income with shareholders picking up the tab</u>. The most obvious impact of the bill would be that companies will be prohibited from deducting compensation, and the increased expense is likely to negatively impact net income and correspondingly shareholder returns. Although a large share of corporate stock is owned by large institutional investors, including employee pension plan assets, it is important to remember that insurance company customers and mutual fund owners are the ones who are likely to be hurt the most, as they depend upon these returns for retirement income.
2. <u>Deferred compensation will be subject to the $1 million cap, discouraging "pay at risk" and further impacting shareholders</u>. By applying the rule to former employees, the bill expands the deduction limitation to the payment of deferred compensation. The approach appears to be an intentional effort to discourage the use of nonqualified deferred compensation. This is ironic because if the company becomes insolvent or files bankruptcy, an executive with deferred compensation is an unsecured

creditor that loses his or her right to the compensation. Further, regulatory requirements for certain financial firms have required the deferral of compensation, thereby making a portion of these payments non-deductible under the proposed legislation although they would have been deductible when actually earned if not required to be deferred.

Bill Aims to Frame Tax Reform Debate With groups jockeying for position on potential tax reform, the proponents of S. 1476 introduced the bill recognizing there is little chance of it becoming law on its own. However, the larger purpose behind S. 1476 is to frame the tax reform debate before it has really started as a way of raising revenue that can be used for other purposes in tax reform or in funding other social programs. The congressional Joint Tax Committee estimated that the bill would raise $50 billion in revenue over 10 years if adopted.

Conclusion The Stop Subsidizing Multimillion Dollar Corporate Bonuses Act is an unsurprising next step in an ongoing, concerted effort to push Congress and regulators into making policy changes aimed at demonizing executive compensation. While the bill has little initial chance of becoming law on its own, it could have an impact in framing how section 162(m) deductions are treated as part of overall tax-reform effort or as a future revenue raising provision.

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