MONEY FOR NOTHING AND THE STOCKS FOR FREE: TAXING EXECUTIVE COMPENSATION

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INTRODUCTION

"There's nothing left," Linda Lay, wife of Enron CEO Kenneth Lay, claimed in an appearance on NBC's Today show while wearing a $15,000 Cartier watch and living in an $8 million penthouse.[1] Mean-

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[1] Daniel Eisenberg, *Is Ken Lay a Victim Too?*, TIME.COM, Feb. 3, 2002, http://www.time.com/time/magazine/article/0,9171,198880,00.html; *The Today Show; Interview of Linda Lay* (NBC television broadcast Jan. 28, 2002).

while, average employees at Enron struggled to figure out what to do now that they were unemployed with no retirement savings, college savings for their children, or severance pay.[2] To these employees, Linda Lay's claim of financial ruin must have been insulting.

In the 1980s and 1990s, the public began to protest the large compensation packages executives were receiving.[3] Average workers were struggling[4] while executives got raises, even as the corporations they worked for failed.[5] This disconnect between executive compensation and executive performance led Congress to attempt to curtail executive compensation.[6] This article will examine the Congress's attempt to temper the amount of compensation through the tax code. These tax code provisions enacted by Congress to restrain excessive executive compensation in fact had the effect of increasing compensation for certain executives at a great cost to stockholders. In 1980, the average CEO made 42 times the average hourly worker's pay.[7] By 1990, the average CEO made 107 times the average hourly worker's pay.[8] In 1993, Congress enacted tax legislation intended to rein in excessive executive compensation.[9] However, in 2000, the average CEO made 525 times the average

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[2] Matthew Scott, *What Investors Can Learn from the Enron Mess*, 32-9 BLACK ENTERPRISE, Apr. 30, 2002, *available at* http://findarticles.com/p/articles/mi_m1365/is_9_32/ai_84212988; Daniel Ruth, *How's It Gonna End, Ken and Linda? Paul Might Know*, TAMPA TRIB., Feb. 8, 2002, at 2.

[3] *See* H.R. REP. NO. 103-111, at 646 (1993), *reprinted in* 1993 U.S.C.C.A.N. 378, 877; *Ceiling Is Urged on Spiraling Pay of Top Managers*, CHI. TRIB., Dec. 17, 1989, at C1; Richard Cohen, Editorial, *Executives' Salaries Are Way out of Line*, ST. LOUIS POST-DISPATCH, Dec. 26, 1991, at 3E; Karen Tumulty, *Corporate Exec Salaries Becoming Political Issue*, CHI. SUN-TIMES, Jan. 1, 1992, at 6; *see also* STAFF OF JOINT COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 199–200 (Comm. Print 1984) (explaining Congress's disallowance of "excess parachute payment[s]").

[4] *See* Steve Lohr, *Recession Puts a Harsh Spotlight on Hefty Pay of Top Executives*, N.Y. TIMES, Jan. 20, 1992, at A1.

[5] *See* H.R. REP. NO. 103-111, at 646, *reprinted in* 1993 U.S.C.C.A.N. 877; John Doyle, *SEC Rules to Give Shareholders Say in Executive Pay*, HOUSTON CHRONICLE, Oct. 16, 1992, at 1, *available at* http://www.chron.com/CDA/archives/archive.mpl?id=1992_1087350; *SEC Strikes Blow for Shareholder Rights Execs' Pay Must Be Disclosed*, REC. N.J., Oct. 16, 1992, at b01.

[6] *See* H.R. REP. NO. 103-111, at 646, *reprinted in* 1993 U.S.C.C.A.N. 877.

[7] AFL-CIO, 2006 Trends in CEO Pay, http://www.aflcio.org/corporatewatch/paywatch/pay/index.cfm (last visited Feb. 18, 2008) [hereinafter AFL-CIO, Trends]; *see* Monica Soto & Bradley Meacham, *Shareholders Take Aim at Lofty CEO Pay Executive Compensation Largely Escapes Belt-Tightening Even when Profits Sink*, SEATTLE TIMES, June 8, 2003, at N12; *You Bought, They Sold*, FORTUNE, Sept. 2, 2002, at 64.

[8] AFL-CIO, Trends, *supra* note 7; *see* Soto & Meacham, *supra* note 7, at N12; *You Bought, They Sold*, FORTUNE, Sept. 2, 2002, at 64.

[9] Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13,211, 107 Stat. 416, 469 (1993) (codified as amended at I.R.C. § 162(m) (West 2007)).

hourly worker's pay.[10] Compensation amounts that executives receive since the enactment of the tax provisions are increasing dramatically, not decreasing.[11]

Some commentators have argued that executive compensation amounts are reasonable because the amounts reflect what the market demands, and as a result, "measures to 'rein-in' executive compensation are ill-advised and possibly counter-productive."[12] Courts have held that the actual amount of compensation does not itself render the compensation unreasonable.[13] In enacting § 162(m),[14] Congress expressed its view that compensation was excessive if the executive's compensation was not adequately tied to the corporation's performance.[15] The purpose of this article is not to enter the debate about whether or not executive compensation is excessive; numerous articles and books have been written on that topic. This article is intended to examine Congress's ultimately unsuccessful attempt to curtail excessive executive compensation through the tax code. Whether Congress's legislative purpose was sound or misguided, these statutes clearly failed to achieve their purpose. The solutions proposed in this article are intended to address the failings in the various pieces of tax legislation that have been enacted to address excessive executive compensation.

Congress believed that linking performance and compensation would adequately address excessive compensation amounts.[16] Stock prices are one indicator of how a corporation is performing, and Congress accordingly enacted tax provisions linking executive compensation to stock performance.[17] The tax provisions sought to convert cash compensation to stock options because it was thought that doing so would

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[10] *See* AFL-CIO, Trends, *supra* note 7; *see News in Brief*, PERSONNEL TODAY, Jan. 1, 2005, at 1; Jeanne Sahadi, *CEO Pay: 364 Times More than Workers*, CNNMONEY.COM, Aug. 29, 2007, http://money.cnn.com/2007/08/28/news/economy/ceo_pay_workers/index.htm.

[11] *See* Sahadi, *supra* note 10 (showing a decrease in the ratio of average CEO pay to average worker pay from 2000 to 2005 but a 9.4% increase in average CEO pay between 2005 and 2006).

[12] Mark J. Loewenstein, *The Conundrum of Executive Compensation*, 35 WAKE FOREST L. REV. 1, 4 (2000) [hereinafter Loewenstein, *The Conundrum*].

[13] *See* Botany Worsted Mills v. United States, 278 U.S. 282, 292 (1929); William S. Gray & Co. v. United States, 35 F.2d 968, 975 (Ct. Cl. 1929).

[14] Hereinafter, all references to "sections" are to the respective sections in the Internal Revenue Code (West 2007).

[15] *See* H.R. Rep. No. 103-111, at 646 (1993), *reprinted in* 1993 U.S.C.C.A.N. 378, 877 ("[E]xcessive compensation will be reduced if the deduction for compensation (other than performance-based compensation) paid to the top executives of publicly-held corporations is limited to $1 million per year.").

[16] *See Executive Compensation: Hearing on S.2298, H.R. 4727 and H.R. 5260 Before the Subcomm. on Taxation of the S. Comm. on Finance*, 102d Cong. 2 (1992) (statement of Sen. David L. Boren, Member, S. Comm. on Finance) ("[W]e would be less concerned about the amount of compensation paid to executives if we believed that pay tracked performance.").

[17] *See* H.R. Rep. No. 103-111, at 648–49, *reprinted in* 1993 U.S.C.C.A.N. 879–80.

align the interests of executives and shareholders by making executives vested owners in the corporation as well.[18] The unintended result was to encourage corporate fraud and accounting misrepresentations intended to inflate earnings and bring executives higher salaries.

The three most important tax code provisions designed to contain or regulate excessive compensation are §§ 162, 162(m) and 280G. Section 162 allows businesses to deduct for compensation paid so long as it is reasonable.[19] This section is rarely, if ever, used to limit compensation.[20] Instead, it is used to re-characterize compensation amounts as other items, such as gifts or dividends.[21] Section 162(m) limits the deduction for executive compensation to $1 million unless the compensation is tied to the performance of either the corporation or the executive.[22] Section 280G denies deductions for excessive amounts paid to certain executives in the event of a change in control in the corporation.[23] None of these sections work as they were intended.[24] On the contrary, they have resulted in even larger amounts of compensation amounts paid to executives at greater cost to shareholders.[25]

This article will seek to demonstrate that the effects of these tax code provisions are in direct conflict with their intended purpose. Part I of this article describes the controversy surrounding excessive executive compensation that gave rise to tax legislation and current proposals to further rein in executive compensation through the tax code. Part II considers §§ 162, 162(m) and 280G of the tax code and their effects on excessive executive compensation and on income and wealth disparity. Part III examines the overall impact of these various code provisions on excessive executive compensation and will suggest several solutions for reducing excessive executive compensation.

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18 *See* Steven Bank, *Devaluing Reform: The Derivatives Market and Executive Compensation,* 7 DEPAUL BUS. L.J. 301, 302, 305 (1995).

19 I.R.C. § 162(a)(1) (West 2007).

20 *See* STAFF OF J. COMM. ON TAXATION, 109TH CONG., PRESENT LAW AND BACKGROUND RELATING TO EXECUTIVE COMPENSATION 6 (Comm. Print 2006) [hereinafter 109TH CONG., EXECUTIVE COMPENSATION]; E.L. Kellett, Annotation, *Reasonableness of Compensation Paid to Officers or Employees, so as to Warrant Deduction Thereof in Computing Employer's Income Tax*, 10 A.L.R. 3d 125 § 3 (2006) [hereinafter Kellett, *Compensation*].

21 *See* 109TH CONG., EXECUTIVE COMPENSATION, *supra* note 20, at 6; Kellett, *Compensation*, *supra* note 20, at § 3.

22 I.R.C. §§ 162(m)(1), (m)(4)(C).

23 I.R.C. § 280G(a)–(b).

24 *See* 109TH CONG., EXECUTIVE COMPENSATION, *supra* note 20, at 7.

25 *See id.*

I. THE DEBATE OVER EXCESSIVE EXECUTIVE COMPENSATION

Executives are often presented with a variety of pay packages. A "golden hello" payment is a large upfront hiring bonus intended to compensate the executive for any bonuses, stock options, pensions, and other compensation that the executive is giving up by leaving his former employer.[26] After a "golden hello" payment, the executive is paid his base cash compensation. Many executives are paid little in base cash compensation in comparison to their overall compensation packages.[27] This lower base cash compensation may be viewed as a public relations technique—an attempt to make the shareholders feel the executive is looking out only for the corporation's best interest. In many cases, however, the executive will receive bonuses in the form of cash, stock, or stock options in addition to base compensation. These bonuses often represent the majority of the total compensation package.[28] Next, the executive will typically receive a pension or other deferred compensation arrangement. Finally, two types of exit payments often exist. "Golden parachute" payments are made in the event that the company merges or is purchased and the new owner does not plan to keep the executive.[29] Severance packages are paid in the event that the executive is terminated. Many of these compensation packages can run into the hundreds of millions of dollars and many are not in the best interest of shareholders.

Median pay of a chief executive officer in 1992 was $2.3 million.[30] The average CEO in an S&P 500 company made $15.06 million in 2006; this was a 11.05% increase over 2005 pay.[31] The average workers pay increased by 1.1% in 2006.[32] Former Federal Reserve Chairman Alan Greenspan described the excessive compensation paid to executives as

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[26] *See, e.g.*, Ben White, *HP Giving Hurd $20 Million "Golden Hello*,*"* WASH. POST, Mar. 31, 2005, at E1.

[27] For example, in 2005 Google's two CEOs were paid $1 in salary but received $1.5 billion and $1.45 billion from stock sales respectively, and the CEO of Kinder Morgan was paid $1 in salary and received $72 million. Michael Brush, CEOs for $1 a Year—Plus Millions More, MSN MONEY, Feb. 1, 2006, http://moneycentral.msn.com/content/P143257.asp.

[28] Moira Herbst, *The Elite Circle of $1 CEOs, Apple's Steve Jobs and Google's Eric Schmidt Are Just Two of the CEOs Who Work for a Buck. Why Do Top Executives Give up Their Salaries?*, BUSINESS WEEK ONLINE, Sept. 17, 2007, http://www.businessweek.com/managing/content/sep2007/ca20070914_637253.htm?campaign_id=rss_null.

[29] *See* I.R.C. § 280G (West 2007).

[30] *See* Kevin Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 847 (2002).

[31] *See* AFL-CIO, Trends, *supra* note 7.

[32] Lynn Brenner, *How Did You Do?*, PARADE.COM, Apr. 15, 2007, http://www.parade.com/articles/editions/2007/edition_04-15-2007/WPE_lead.

"infectious greed."[33] He further commented that "[u]nnecessarily high executive compensation can also be a misallocation of resources and a drain on the economy."[34]

The debate over executive compensation and whether or not it is excessive is not new. The debate reignites every few years and results in legislative acts aimed at reining in perceived excessive compensation.[35] Commentators have argued that if shareholders were better-informed and the compensation amounts were adequately disclosed to shareholders, shareholders would exert their influence to keep executive compensation levels in check.[36] Still others have argued that the issue of excessive executive compensation should be addressed at the board of director level by compensating the board with stock, thus making them less beholden to management and more invested in the efficiency of the corporation.[37]

Some commentators have proposed addressing the issue of compensation from the perspective of the "rank and file workers" at corporations.[38] Some proposals would tie executive compensation to the average worker's salary.[39] For example, a proposal was made to limit

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33 *Testimony of Alan Greenspan Before the S. Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. (July 16, 2002), http://www.federalreserve.gov/boarddocs/hh/2002/july/testimony.htm.

34 Joshua A. Kreinberg, Note, *Reaching Beyond Performance Compensation in Attempts to Own the Corporate Executive*, 45 DUKE L.J. 138, 145 (1995).

35 *See* Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312, (1993) (codified as amended at I.R.C. § 162(m) (West 2007)); Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, (1984) (codified as amended at I.R.C. §§ 280G, 4999); Small Business and Work Opportunity Act of 2007, S. 349, 110th Cong. (2007) (proposing a cap on deferred compensation payments similar to that found in § 162(m)); JOINT COMMITTEE ON TAXATION, 110TH CONG., DESCRIPTION OF THE CHAIRMAN'S MODIFICATION OF THE PROVISIONS OF THE "SMALL BUSINESS AND WORK OPPORTUNITY ACT OF 2007," at 25 (Comm. Print 2007); *see also* Income Equity Act of 1999, H.R. 740, 106th Cong. (1999) (proposing a limitation on a corporation's deduction of executive compensation up to twenty-five times the lowest paid employee in the corporation); Income Disparities Act of 1991, H.R. 3056, 102d Cong. (1991) (same).

36 *See* James A. Cotton, *Toward Fairness in Compensation of Management and Labor: Compensation Ratios, a Proposal for Disclosure*, 18 N. ILL. U. L. REV. 157, 179 (1997) (proposing that corporations disclose to their shareholders the ratio between their average employee's compensation and their top executives' compensation).

37 *See* Charles M. Elson, *Executive Overcompensation—A Board Based Solution*, 34 B.C. L. REV. 937, 942–44 (1993).

38 *See* Gerald P. Buccino, *Shareholder Uprising: Is It SOX, or Are They Simply Fed Up?*, 24-5 Amer. Bankr. Inst. J. 30, 30 (2005) (noting that shareholders at Merrill Lynch & Co., Citigroup Inc., Wells Fargo & Co., Lockheed Martin Corp., International Paper, and Marsh & McLennan Cos. have voted on a proposal to limit chief executive officer pay to one hundred times the average compensation paid to non-managerial workers in the prior year); Cotton, *supra* note 36, at 179 (arguing for disclosure in proxy statements to shareholders of the ratio of executive pay to the average employees in the company); Susan J. Stabile, *One for A, Two for B, and Four Hundred for C*: *The Widening Gap in Pay Between Executives and Rank and File Employees*, U. Mich. L.J. Reform 115, 156–57 (2002); *see also* H.R. 740; H.R. 3056.

39 *See* Cotton, *supra* note 36, at 179; Stabile, *supra* note 38, at 156–57.

executive compensation to twenty-five times what the average worker is paid.[40] The CEO of Costco, James Sinegal, earns $558,000 a year and believes that paying a CEO ten to twelve times the highest hourly rate is fair.[41]

Shareholders should profit from an increase in stock price and executives should profit from performing well. The performance of an executive, however, may or may not be reflected in an increase in stock price. The assumption that if stock price goes up the executives should be compensated at a higher rate does not appear to have any merit. Several studies and law review articles have noted that a tie between higher levels of performance and stock options may not exist.[42]

By 2001, almost 52% of families held stock, either directly or through plans such as mutual funds and 401(k)s.[43] If the wealth of corporations was distributed to the shareholders, rather than to the executives, this would be more consistent with congressional intent to reduce excessive executive compensation and provide greater returns to shareholders.[44]

Shareholders at many corporations appear to be frustrated by the levels of executive compensation and many are pushing for a change. In 2005, shareholders of several corporations raised issues relating to executive compensation that they wanted addressed and wanted the right to vote on. For example, shareholders voted on proposals to limit executive compensation to the amount that would be deductible at Merck & Co. Inc., Bank of New York, Honeywell International, Inc., Citigroup Inc. (excluding the chief executive officer), Motorola Inc., Colgate-Palmolive Company, and The Home Depot USA Inc.[45] Other shareholders have voted on proposals to limit CEO compensation to 100 times the average compensation paid to non-managerial workers in the prior year, to separate the chairman of the board position from the CEO position, to curb excessive compensation, and to require the compensation committee of the corporation to review executive compensation.[46]

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[40] *See* H.R. 740; H.R. 3056.

[41] *See* Michael Brush, *Extravagant CEO Pay Is Back*, MSN MONEY, Mar. 15, 2005, http://moneycentral.msn.com/content/P110762.asp.

[42] *See* Kevin Murphy, *Executive Compensation, in* 3B HANDBOOK OF LABOR ECONOMICS 2485, 2539 (Orley Ashenfelter & David Cards eds., 1999) (stating "there is surprisingly little direct evidence that higher pay-performance sensitivities lead to higher stock performance.").

[43] *See* Barbara Hagenbaugh, *Nation's Wealth Disparity Widens*, USA TODAY, Jan. 22, 2003, at 1A, *available at* http://www.usatoday.com/money/economy/fed/2003-01-22-household-study_x.htm.

[44] James Repetti, *The Misuse of Tax Incentives to Align Management-Shareholder Interests*, 19 CARDOZO L. REV. 697, 700 (1997).

[45] *See* Buccino, *supra* note 38, at 30.

[46] Such proposals were made at Merck & Co., Honeywell International, Inc., The Boeing Company, Pfizer Inc., Citigroup Inc., Wells Fargo & Co., Bristol Meyers Squibb Co., Lockheed Martin Corp., Marsh & McLennan Cos., and Amgen Inc. *Id.*

High levels of executive compensation may also interfere with the best interests of corporations and shareholders by preventing the enactment of tax legislation that might reduce corporate tax rates. One United States Senator noted that "we open the paper and see huge compensation packages, $200 million; $400 million as a walk away . . . . The fallout of some of those makes it very difficult for us to say let us reduce rates."[47] The political climate and the public's discouragement with the excessive amounts of compensation hinder legislative action that could benefit corporations and shareholders.

Commentators often characterize the public complaints about excessive executive compensation as "populist" complaints from employees whose industries have become obsolete or by workers who are suffering losses.[48] Complaints that compensation packages paid to executives are unjust should not be dismissed as complaints by workers who have fallen on hard times. The frequency of such complaints makes it critical to consider the possibility that the injustice is real. In fact, in response to requirements that corporations report stock option grants to executives on their financial statements, corporations have begun to examine the transfer of wealth from shareholders to executives through stock options.[49] As one consultant noted, boards have been calculating the "sheer

[47] *Corporate Tax Reform: Hearing Before the H. Comm. on Ways and Means*, 109th Cong. 109 (2006) (statement of Sen. Mark Foley, Member, House Comm. on Ways and Means).

[48] *See* Kevin Murphy, *Politics, Economics and Executive Compensation*, 63 U. CIN. L. REV. 713, 713 (1995) (quoting Thomas McCarroll, *The Shareholders Strike Back: Executive Pay*, TIME, May 4, 1992, at 46). Murphy also states:

> Recognizing the populist attack on wealth as a response to inevitable wealth redistributions adds perspective to the political forces underlying the pay controversy. Workers in obsolete sectors suffer from technological growth while those earning union wages suffer from increasing non-unionized domestic and global competition. Even workers who remain employed in established industries experience real losses in their human capital and future promotion prospects. It is both predicable and understandable that the collective frustration of these workers will be vented as an attack on the highly paid CEOs and others perceived to be benefiting from the economic turmoil.

Id. at 717. Characterizing the public's complaints on wealth disparity as complaints from "workers in obsolete sectors" is unfair. Workers are not complaining simply because they are in obsolete sectors or have suffered a loss in human capital, but rather because the overall disparity in wealth continues to grow. The vast amount of wealth disparity is not only unfair but bad public policy. It is a threat to democracy in that it creates a plutocracy. *See* Stabile, *supra* note 38, at 154 (stating that "[i]t is leading toward the transformation of the United States from a middle-class democracy into something that more closely resembles an authoritarian quasi-DEMOCRACY with an overclass, an underclass, and a hidden politics driven by money." (quoting JAMES K. GALBRAITH, CREATED UNEQUAL: THE CRISIS IN AMERICAN PAY 6 (1998)).

[49] *See Oversight Hearing on Expensing Stock Options: Supporting and Strengthening the Independence of The Financial Accounting Standards Board: Hearing Before the Subcomm. on Financial Management, the Budget, and Int'l Security of the S. Comm. on Governmental*

size of this wealth transfer. In many cases, the findings have been a shocking but necessary eye-opener for the board."[50]

II. THE TAX PROVISIONS THAT SEEK TO REGULATE EXCESSIVE COMPENSATION

A. SECTION 162

Section 162 allows corporations to deduct a "reasonable allowance" for compensation.[51] Determining whether compensation is reasonable is a question of fact based on the circumstances surrounding the compensation amount.[52] The term "reasonable allowance" is not defined by the tax code or the Treasury regulations.[53] To be deductible, the compensation amount must be "ordinary and necessary."[54]

The amendment providing a deduction for a "reasonable allowance" for compensation was added in 1918, but the legislative history does not reveal the congressional intent behind the clause's enactment.[55] Commentary implies that Congress added the amendment to § 162 in order to specifically include a provision in the statute allowing a compensation deduction to ensure that businesses would not hesitate to take the deduction.[56] The theory was that corporations had been uncomfortable taking such a deduction because they were unsure whether such a deduction for compensation was really permitted.[57] Congress added § 162 to reduce fear among corporations that courts or the Treasury Department would challenge their deductions.[58]

The Treasury regulations under § 162 provide that salaries are subject to careful analysis and that if they are out of proportion to the volume of the business or are excessive when compared to the salaries of like officers or employees of similar corporations the excess amount is not deductible.[59] Courts are to analyze the reasonableness of the com-

Affairs, 108th Cong. 102 (2004) (written testimony of Donald P. Delves, President, The Delves Group) [hereinafter *Oversight Hearing*].

50 *See id.*

51 I.R.C. § 162(a)(1) (West 2007).

52 *See* Long Island Drug Co., Inc., v. Comm'r, 111 F.2d 593, 594 (2d Cir. 1940); Wagner & Son v. Comm'r, 93 F.2d 816, 818 (9th Cir. 1937).

53 *See* I.R.C. § 162(a)(1); Treas. Reg. § 1.162-7 (1960).

54 I.R.C. § 162(a).

55 *See* S. REP. NO. 65-617 (1918).

56 *See* Erwin Griswold, *New Light on "A Reasonable Allowance for Salaries,"* 59 HARV. L. REV. 286, 288 (1945) (stating that the language in then § 234(a)(I) of the Revenue Act of 1918 was intended to be liberalizing language rather than a restriction on the deduction of executive compensation).

57 *See id.* at 287.

58 *See id.* at 290.

59 *See* Treas. Reg. § 1.162-7(b)(3) (1960).

pensation paid to an executive on a case by case basis.[60] However, courts have not applied the reasonableness standard to limit the amount of compensation. Rather, they have applied the standard primarily to limit payments by closely held companies where those companies have tried to disguise nondeductible dividends as compensation which would be deductible.[61]

A deduction for compensation under § 162 will be permitted if the compensation is an ordinary and necessary expense.[62] Furthermore, if the deduction is for a "reasonable allowance" of salary, the amount of that compensation must be reasonable.[63] In most cases compensation for an executive is a necessary business expense because almost all corporations must pay compensation to their employees, including executives. The deductibility of the compensation therefore really hinges on whether a court will consider the amount reasonable.

No uniform test exists to determine if compensation is reasonable or if the amounts are ordinary and necessary. In trying to make such determinations, courts have used an assortment of factors, according a certain amount of weight to each factor.[64] The lack of a precise rule, a consistent list of factors, or guidance on how to weigh each factor have led to confusion over whether compensation amounts are reasonable.[65]

In *Mayson Manufacturing Co. v. Commissioner*, the Sixth Circuit listed nine factors used to evaluate whether compensation was deductible. While courts may use variations on the factors or weigh them differently, the factors laid out in *Mayson* frequently form the basis for the analysis.[66]

The nine factors that the Sixth Circuit set out in *Mayson* were: (1) the employee's qualifications for the job; (2) the nature, scope and extent of work actually performed by the employee; (3) the size and complexity of the business enterprise; (4) the economic conditions and background of the industry involved; (5) the particular company's dividend history;

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60 Kellett, *Compensation*, *supra* note 20, at §§ 2–3.

61 H.R. REP. NO. 103-111, at 646 (1993), *reprinted in* 1993 U.S.C.C.A.N. 378, 877; 109TH CONG., EXECUTIVE COMPENSATION, *supra* note 20, at 6.

62 I.R.C. § 162(a) (West 2007).

63 I.R.C. § 162(a)(1).

64 Kellett, *Compensation*, *supra* note 20, at § 3.

65 *Compare* Denison Poultry & Egg Co. v. United States, 83-1 U.S. Tax Cas. (CCH) P9360 (1982) (holding that the compensation was reasonable and therefore deductible), *with* Clymer v. Comm'r, 47 T.C.M. (CCH) 1576 (1984) (holding that the compensation was not reasonable or deductible).

66 *See* Mayson Mfg. Co. v. Comm'r, 178 F.2d 115, 119 (6th Cir. 1949); *see also* Dexsil Corp. v. Comm'r, 147 F.3d 96, 100 (2d Cir. 1998); Rutter v. Comm'r, 853 F.2d 1267, 1271 (5th Cir. 1988) (citing the *Mayson* factors); Automatic Cigarette Sales Corp. v. Comm'r, 234 F.2d 825, 827 (4th Cir. 1956); Dick Bros. v. Comm'r, 205 F.2d 64, 67 (3d Cir. 1953) (citing *Mayson* but not explicitly listing the factors).

(6) a comparison of the compensation paid with the compensation paid to other similarly situated employees at similar businesses of the same size; (7) the compensation being paid to the company's other employees; (8) the amount of compensation that the employee received in prior years; and (9) a comparison of compensation amounts to distributions made to shareholders.[67] Other courts have added additional factors, such as the financial condition of the corporation, to determine whether compensation paid to an executive was reasonable.[68] Moreover, no single factor is determinative. Rather, a court must weigh the factors against one another to determine if the compensation is reasonable.[69]

The Internal Revenue Service Manual lays out twelve factors that an agent should use when evaluating whether compensation is reasonable. They include (1) the nature of the employee's duties; (2) the background and experience of the employee; (3) the employee's knowledge of the business; (4) the business's size; (5) the employee's contribution to profit making; (6) the time devoted by the employee; (7) the general economic conditions; (8) the economic conditions locally; (9) the character and amount of responsibility of the employee; (10) the time of year when compensation is determined; (11) whether the compensation is really a payment for a business or for assets acquired; and (12) a comparison of similarly situated employees in similar businesses of the same size.[70] Again, no one factor is determinative; all the factors must be weighed against one another to determine if the compensation is reasonable.[71]

Later courts developed an independent investor test. Under this test compensation was reasonable and therefore deductible if an independent investor, evaluating all of the relevant factors, believed that the compensation was fair.[72]

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[67] *Mayson*, 178 F.2d at 119.

[68] *See* Austin v. United States, 28 F.2d 677, 678 (5th Cir. 1928); Brown-Forman Distillers Corp. v. United States, 132 F. Supp. 711, 716–17 (Ct. Cl. 1955); Herff Motor Co. v. McCabe, 41 F. Supp. 1011, 1013 (M.D. Tenn. 1939), *aff'd sub nom* Nashville Trust Co. v. Herff Motor Co., 122 F.2d 1022 (6th Cir. 1941); *see also* Foos v. Comm'r, 41 T.C.M. (CCH) 863, 878–79 (1981) (listing twenty-one different factors used to determine if compensation was reasonable). *But see* Heywood Boot & Shoe Co. v. Comm'r, 76 F.2d 586, 588 (1st Cir. 1935) (stating that, although the executives were shareholders, they were not trying to hide a distribution of corporate profits as compensation); Ox Fibre Brush Co. v. Blair, 32 F.2d 42, 48 (4th Cir. 1929), *aff'd sub nom* Lucas v. Ox Fibre Brush Co., 281 U.S. 115 (1930) (choosing not to compare compensation amounts to the value of the outstanding capital stock).

[69] Irby Constr. Co. v. United States, 290 F.2d 824, 826 (Ct. Cl. 1961); *see also* Miller Mfg. Co. v. Comm'r, 149 F.2d 421, 424 (4th Cir. 1945).

[70] I.R.S. Manual 4.35.2.5.2.2 (May 5, 2006).

[71] *See Irby*, 290 F.2d at 827.

[72] Exacto Spring Corp. v. Comm'r, 196 F.3d 833, 838 (7th Cir. 1999) (holding that the executive's compensation was reasonable because investor would get a twenty percent return after its payment to the executive which was higher than the 13% return the government had stated that investors would have expected); *see also* Dexsil Corp. v. Comm'r, 147 F.3d 96,

Comparison with the compensation amounts received by other similarly situated executives is a very important factor that is often used to determine whether compensation amounts are reasonable.[73] This is particularly true because it is one of the factors specifically addressed in the Treasury regulations. The regulations compare compensation amounts for similar services at like businesses as one of the factors to determine if compensation is reasonable.[74] Courts may also compare an executive's compensation to that of workers at the same corporation.[75]

Because executive salaries have become so uniformly high, it appears unlikely that many of the high levels of compensation will be deemed unreasonable under § 162 when compared to other executive salaries.[76] Boards of directors frequently evaluate what other executives are being paid when determining the salary for the executives in their corporation.[77] In fact, "as a practical matter, boards and compensation committees cannot set pay without regard to the pay of executives in comparable firms."[78] Because the going rate for an executive can often run into the millions, tens of millions, or, in some cases, hundreds of millions of dollars, even extremely high salaries will be reasonable in comparison to the salaries of similarly-situated executives under § 162.[79]

Courts will not consider a compensation package unreasonable based on its size alone.[80] If a compensation amount or portion of compensation paid is deemed unreasonable, then it will not be deductible to the corporation. The Internal Revenue Service (IRS) or the courts will leave such compensation as non-deductible unreasonable compensation and will not re-characterize it as another type of corporate expense unless the facts support such re-determination.[81] If the IRS determines that an

100–01 (2d Cir. 1998) (describing the "independent investor" test); Elliotts, Inc. v. Comm'r, 716 F.2d 1241, 1245 (9th Cir. 1983).

73 *See* Kellett, *Compensation*, *supra* note 20, at § 8; *see also* Botany Worsted Mills v. United States, 278 U.S. 282, 290–92 (1929) (holding that the executive's compensation was not reasonable but noting that paying the executives through profits in the corporation was typical of similar companies in the same industry).

74 *See, e.g.*, *Botany Worstead Mills*, 278 U.S. at 290–92.

75 *See* United States v. Ragen, 314 U.S. 513, 525–26 (1942); Pinkham Medicine Co. v. Comm'r, 128 F.2d 986, 989 (1st Cir. 1942).

76 Comparison with the compensation of other executives is one of the factors to determine reasonable compensation. *See* Kellett, *Compensation*, *supra* note 20, at § 8. Because compensation amounts have increased, when a comparison of similarly situated executives is made, the amounts will be increased in line with the higher amounts that other executives are receiving, even if those amounts are exceedingly high.

77 Loewenstein, *The Conundrum*, *supra* note 12, at 8.

78 *See id.*

79 *See id.*

80 William S. Gray & Co. v. United States, 35 F.2d 968, 974 (Ct. Cl. 1929).

81 Sterno Sales Corp. v. United States, 345 F.2d 552, 554 (Ct. Cl. 1965).

amount of compensation is unreasonable, then the burden is on the taxpayer to show that the compensation was reasonable.[82]

Corporations often pay executives the most cost-effective amount for the results the corporation expects from the executive.[83] Courts should apply a multi-factorial test when determining whether compensation is reasonable because each business has its own unique circumstances and job requirements for an executive. Comparisons to similarly-situated executives should be a critical factor, as should the individual performance of the executive and the ultimate results to the corporation. The test should be based on a cost-benefit analysis. Perhaps the skill set that the executive brings to the table merits a large amount of compensation. The IRS must, however, be suspicious of large compensation amounts when they deviate from the standard comparable amounts. The IRS must evaluate whether the compensation amounts are indeed reasonable when examining the skills of the executive. The independent investor test will be critical in this respect.

Until now, the enforcement of reasonable compensation has focused on recharacterizing the compensation as dividends, gifts, or other types of corporate payment.[84] Section 162 (a)(1) lays out all of the rules necessary to ensure that boards of directors and executives who seek to pay unjustified amounts of compensation do not exploit their shareholders and corporations. The courts must test for "reasonableness" to determine both when compensation amounts are too low and also when compensation amounts are too high. Congress decided to act when it found that courts were not applying the reasonableness test to find compensation excessive.[85] Congress enacted § 162(m) to further define what it deemed to be reasonable compensation paid by a corporation.

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[82] *See* Perlmutter v. Comm'r, 44 T.C. 276, 289 (1965).

[83] See *In re* Walt Disney Co., 907 A.2d 693, 746 n.402 (citing Sean Griffith, *Good Faith Business Judgment: A Theory in Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1 (2005)).

[84] *See* Kellett, *Compensation*, *supra* note 20, at § 3 (stating, "While it is true that compensation must meet the test of reasonableness regardless of whether or not the employee is a stockholder of the corporate employer, as a practical matter the compensation of a nonstockholder and unrelated employee is rarely challenged, since the fact that the salary or compensation is set by arm's-length negotiations ordinarily establishes its reasonableness, and it is only in the rare instances where the salary paid an unrelated employee is completely out of line with any standards of reasonableness that the compensation will be challenged."); *see also* H.R. REP. NO. 103-111, at 646 (1993), *reprinted in* 1993 U.S.C.C.A.N. 378, 877; 109TH CONG., EXECUTIVE COMPENSATION, *supra* note 20, at 6.

[85] *See infra* Part II.B.1.

B. SECTION 162(m)

1. *The Reasons Behind § 162(m)*

Congress enacted § 162(m) to rein in excessive executive compensation. Two things happened in reaction to the provision. Corporations changed their behavior, and in many cases stock options became the primary form of executive compensation, increasing the amounts of pay. Also, some corporations ignored the limitations imposed by § 162(m). The costs of both of these results were ultimately borne by shareholders.

During the late 1980s and early 1990s, a consensus developed that salaries for some executives had become excessive.[86] The economy, from the perspective of ordinary workers, was not doing particularly well, yet the compensation of some executives was increasing dramatically.[87] The complaints grew louder when President George H.W. Bush traveled to Japan with automobile executives from the United States.[88] Media coverage of the trip compared the American executives' salaries with those of their Japanese counterparts, which were significantly lower.[89] The U.S. public demanded a change. Section 162 did not limit the amount of compensation paid to executives; it only required that compensation be reasonable. When the courts applied § 162, they did so only to re-characterize compensation and not to regulate the actual amounts of compensation.[90] Executive salaries at many corporations continued to rise every year by percentages in the double digits, while the value of the same corporations' stock continued to drop.[91] There was a great deal of public concern about the fact that executives continued to get raises even while the corporations that employed them fared poorly.[92]

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[86] *See* Cohen, *supra* note 3, at 3E; Tumulty, *supra* note 3, at 6; *see also* H.R. REP. NO. 103-111, at 201 (1993).

[87] *See* David Francis, *How to Roll Back the Pay of the Boss*, CHRISTIAN SCIENCE MONITOR, May 17, 1991, at 9; Steve Lohr, *Recession Puts a Harsh Spotlight on Hefty Pay of Top Executives*, N.Y. TIMES, Jan. 20, 1992, at A1; Bill Sing, *Stock Rights Proved to Be the Quickest Way to Higher Pay and a Place Among California's 100 Top-Earning Executives*, L.A. TIMES, May 22, 1988, at 1; Bob Wiemer, *The Coming Crisis Over Corporate Pay*, NEWSDAY, July 17, 1995, at A24.

[88] *See* Alison Leigh Cowan, *The High-Energy Board Room*, N.Y. TIMES, Oct. 28, 1992, at D1; *Executive Pay Top Issue at Annual Meetings; Corporations: Federal Regulators Have Made It Easier this Year for Shareholders to Understand and Speak up About the Financial Rewards Management Receives*, L.A. TIMES, Feb. 16, 1992, at D7; *see also* Art Buchwald, *America, on Auto Pilot*, WASH. POST, Jan. 16, 1992, at C1.

[89] *See* sources cited *supra* note 87.

[90] 109TH CONG., EXECUTIVE COMPENSATION, *supra* note 20, at 6.

[91] Doyle, *supra* note 5, at 1; *SEC Strikes Blow for Shareholder Rights Execs' Pay Must Be Disclosed*, *supra* note 5, at b01; *see also* sources cited *supra* note 86.

[92] *See* sources cited *supra* note 86.

During his presidential campaign, Bill Clinton promised to rein in the excessive compensation paid to executives.[93] As a result, in 1993, Congress enacted § 162(m).[94] The provision was intended to reduce excessive amounts of compensation by providing that a corporation would not be permitted to deduct compensation that exceeded $1 million.[95] Exceptions to this limitation allowed corporations to pay executives more and take a deduction for the compensation paid as long as the motive for additional compensation was consistent with the goals of Congress, specifically to link executive compensation with the performance of the executive and the corporation.[96] Unfortunately, although § 162(m) appears to have been well-intended, the provision has caused some presumably unintended consequences.

The Senate Committee report on § 162(m) specifically states that the $1 million limitation was not intended to "modify the present-law requirement that in order to be deductible compensation must be reasonable."[97] Therefore, the requirements of § 162, that compensation be ordinary, necessary, and reasonable are still in full effect. Congress essentially imposed its own cap on what it viewed as reasonable compensation: $1 million or less, unless the amounts received were performance-based. Congress made no exception for different types of industries, experience of the executive, or any of the other factors laid out by the courts.[98] Further, the provisions only apply to publicly-held corporations.[99]

Section 162(m) provides that deductible compensation is limited to $1 million for publicly-held corporations unless the compensation is based on performance, the corporation receives the approval of the shareholders, and an independent compensation board determines the criteria on which the compensation award is based.[100] Performance-based compensation is compensation that the executive receives once the executive achieves a certain goal.[101] The theory behind the performance-based exception was that the amount of compensation alone does not make com-

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[93] *See* 109TH CONG., EXECUTIVE COMPENSATION, *supra* note 20, at 6; Susan J. Stabile, *Is There a Role for Tax Law in Policing Executive Compensation?*, 72 ST. JOHN'S L. REV. 81, 87–88 (1998).

[94] *See* Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13.211, 107 Stat. 416, 469 (1993) (codified as amended at I.R.C. § 162(m) (West 2007)).

[95] *See* I.R.C. § 162(m)(1).

[96] *See* H.R. REP. NO. 103-111, at 647 (1993).

[97] *See* SEN. COMM. R., *Revenue Reconciliation Act of 1993*, § 13211, n.1.

[98] *See, e.g.*, I.R.C. § 162(m).

[99] *See* I.R.C. § 162(m)(2).

[100] *See* I.R.C. §§ 162(m)(1), 162(m)(4)(C). A corporation is considered publicly held if it has a class of common equity securities that are required to be registered under § 12 of the Securities Exchange Act of 1934. I.R.C. § 162(m)(2).

[101] I.R.C. § 162(m)(4)(C).

pensation unreasonable, and if the amount were tied to better performance in the corporation and the executive, then the amount of compensation would be reasonable.[102] Section 162(m) applies to the chief executive officer and any of the four highest-paid employees of the corporation.[103] The term compensation is intended to include all cash payments, benefits, and any other remuneration paid in any forms other than cash.[104] If stock options do not meet the performance-based exception, they are included in the $1 million cap when they are exercised—not when they are granted.[105] This is so even if the options are related to services that were performed in an earlier year.[106]

An executive who receives stock options is receiving the right to purchase the corporation's stock at a specific price during a certain time period. An example of a stock option grant that is not subject to the $1 million cap of § 162(m) would be a grant to an executive for the right to buy 5,000 shares of the company at $25 a share. If shares of the company currently trade at $25 a share, the executive will not actually realize any compensation from the grant until the shares increase in value to $26 a share.[107] At that point, if the executive exercises his right to buy the shares, then the executive will end up with $1 of profit per share (or $5,000 total). Section 162(m) excludes this type of compensation from the cap because it is implicitly performance-based; the executive only profits from the grant of stock options if the stock price actually increases. The executive will therefore try to increase the stock price in the corporation by performing well. Because the shareholders also want to have the stock price in the corporation increased, the shareholders' and

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102 *See* Gray & Co. v. United States, 35 F.2d 968, 975 (Ct. Cl. 1929); Botany Worsted Mills v. United States, 278 U.S. 282, 292 (1929); *see also* H.R. Rep. No. 103-111, at 646, *reprinted in* 1993 U.S.C.C.A.N. 378, 877. Some commentators have stated that "we cannot reliably distinguish good CEOs from bad. . . . Even in hindsight, it is impossible to sort out exactly how much of a firm's success or failure was due to the individual CEO." Franklin Snyder, *More Pieces of the CEO Compensation Puzzle*, 28 DEL. J. CORP. L. 129, 145 (2003).

103 I.R.C. § 162(m)(3). This is based on the disclosure requirements under the Securities Exchange Act of 1934. *See* I.R.C. § 162(m)(3)(2); STAFF OF J. COMM. ON TAXATION, 107TH CONG., PRESENT LAW AND BACKGROUND RELATING TO EXECUTIVE COMPENSATION 27 (Comm. Print 2002) [hereinafter 107TH CONG., EXECUTIVE COMPENSATION].

104 *See* I.R.C. § 162(m)(4)(E). Compensation also includes all compensation the executive receives from the corporation regardless of when the compensation was earned or whether the compensation is for services as a covered employee unless the compensation is specifically excluded from the deduction limitation. *See* 107TH CONG., EXECUTIVE COMPENSATION, *supra* note 103, at 27. Compensation that is not included in § 162(m) includes commissions, compensation payable solely because of the attainment of one or more performance goals, payments to a tax-qualified retirement plan, amounts otherwise excluded from the executive's pay, and any compensation pursuant to a contract in effect prior to February 17, 1993. *See* I.R.C. § 162(m)(4).

105 *See* Treas. Reg. § 1.162-27(e)(2)(vi) (1996).

106 *See* SEN. COMM. R., *Revenue Reconciliation Act of 1993*, § 13211.

107 *See id.*

the executive's interests are aligned and the executive has an added incentive to perform well for the corporation.

Stock options that have an exercise price below the current price of shares (referred to as in-the money options) are not exempt from the $1 million cap.[108] An in-the money stock option, for example, would be if our executive in the previous example was granted an option to purchase stock at $20 when the market share price was $25. The executive does not have to perform well (or perform at all) to profit from the grant. As soon as the options are granted the executive will profit $5 per share. Therefore, the performance-based exception does not apply.[109] The same principle applies to re-pricing stock options. If in our example above the executive is given the right to purchase stock options at $25 while stock prices are $25 a share, and then share price drops to $12 a share, at which point the executive's stock options are re-priced to $12 a share, then the executive does not have to perform well to realize any profits. If stock price and executive performance are correlated, the executive has in fact performed badly and yet will still be rewarded. Therefore, re-priced options are not exempt from the $1 million cap of § 162(m).[110]

The two types of stock options that are typically granted as compensation to executives are statutory stock options and nonqualified stock options.[111] Statutory stock options are not included in the gross income of the executive when the executive receives the grant or when the executive exercises the option.[112] The corporation itself is not allowed a deduction on the grant or exercise of the statutory stock options.[113] Once the executive actually sells the stock he received by exercising his stock options, the employee is taxed at capital gains rates on the excess of the amount he receives on the sale over the exercise price of the stock options.[114] The corporation is still not entitled to a deduction.[115] If the exercise price was set below the price of stock at the time of the grant, then the amount between the exercise price and the fair market value of the stock at the time of grant will be ordinary income.[116] The corporation will still not be entitled to a deduction.[117]

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108 *See* H.R. REP. NO. 103-111, at 21 (1993); Treas. Reg. § 1.162-27(e)(2)(vi)(B) (1996).

109 *See* SEN. COMM. R., *Revenue Reconciliation Act of 1993*, § 13211.

110 *See* Treas. Reg. § 1.162-27(e)(2)(vi)(B) (1996).

111 *See* 109TH CONG., EXECUTIVE COMPENSATION, *supra* note 20, at 34.

112 *See id.* at 38.

113 *See id.*

114 *See id.*

115 *See id.*

116 *See id.*

117 *See id.*

Nonqualified stock options are another type of stock option that executives may receive. These options are used more often than statutory stock options, presumably because the income to the executive is deductible to the corporation as a compensation expense.[118] Nonqualified stock options are only included into an executive's gross income on the grant of the option if the option has a readily ascertainable fair market value at the time the option is granted.[119] Generally nonqualified stock options do not have a readily ascertainable fair market value; however, if they do, the amount of the fair market value of the option over what was paid for the option is included in the executive's gross income on the grant.[120] If the option does not have a readily ascertainable fair market value, then the executive does not have any gross income on the grant. Instead, when the executive exercises the options, he will have ordinary income equal to the fair market value of the stock he receives, less his cost.[121] The corporation will get a compensation deduction equal to the amount of the executive's gross income.[122]

There are four requirements of the performance-based exception in § 162(m): 1) compensation paid to an executive is paid solely for meeting one or more performance goals; 2) a compensation committee consisting of two or more outside directors approved the performance goals;[123] 3) the shareholders approve the material terms for which the compensation will be paid, including the performance goals; and 4) prior to the payment, the committee certified that the executive met the performance goals.[124] To be valid under the performance exception, the compensation and goals must be clear enough that a third party with knowledge of the performance results could calculate the amount of compensation that the executive would receive.[125]

A deduction for stock options will not be subject to the limitations of § 162(m) as long as the shareholders have approved of the plan and an independent board of directors has approved the criteria.[126] The requirements were intended to ensure that shareholders approved of the com-

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118 *See id.* at 34–35.

119 *See id.* at 34.

120 *See id.*

121 *See id.*

122 *See id.*

123 A director is considered an outside director if he or she is not a current employee of the corporation (or related entities), is not a former employee of the corporation (or related entities) who is receiving compensation for prior services (other than payments under a tax-qualified pension plan), was not an officer of the corporation (or related entities) at any time, and is not currently receiving compensation for personal services from the corporation other than in his or her capacity as a director. *See* Treas. Reg. § 1.162-27(e)(3)(i) (1996).

124 109TH CONG., EXECUTIVE COMPENSATION, *supra* note 20, at 4.

125 *Id.*

126 *See* I.R.C. § 162(m)(4)(C) (West 2007); Treas. Reg. § 1.162-27(e)(2) (1996).

pensation and the compensation is tied to the performance of the executive and the corporation. With the approval of the shareholders and a link between compensation and performance, the corporation does not have to forgo corporate deduction for the executive's pay.[127] If compensation is tied to performance, the compensation is not considered excessive.[128] To meet the shareholder approval requirement in the exception under § 162(m), a majority of the shares voted must approve the compensation, or the compensation plan, in a separate vote.[129]

The requirement that a compensation committee certify the achievement of performance goals is not necessary in the case of stock option grants. Stock options and other stock appreciation rights automatically meet the performance exception so long as they are approved both by shareholders and an independent board of directors.[130] The certification requirement is unnecessary for such grants because they tie the amount of compensation to the increase in the corporation's stock price, which the law considers an objective indicator of executive performance.[131] Grants of restricted stock do not qualify for the performance-based exception unless the executive is required to meet independent performance requirements to receive them.[132] In addition, the requirement that a third

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[127] *See* I.R.C. § 162(m)(4)(C). In addition to the enactment of § 162(m), in 1993 the Securities and Exchange Commission also enacted several disclosure rules for corporations to their shareholders. Congress required that not only must the compensation be disclosed to the shareholders in the annual proxy statements, but that it be disclosed in chart form. *See* 17 C.F.R. § 229.402 (1992); Executive Compensation Disclosure, Securities Act Release No. 6962, Exchange Act Release No. 31,327, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,056 (Oct. 16, 1992). Anecdotal evidence suggests that prior to the disclosure in charts, the compensation of executives was undeterminable in proxy statements—even to institutions investors. *See 1994 Corporate Law Symposium: Presentations and Panel Discussion*, 63 U. CIN. L. REV. 769, 770–71 [hereinafter *Corporate Law Symposium*]. Corporations, or perhaps their lawyers, buried the approval in shareholder proxy forms. Initially shareholders had trouble finding and understanding the compensation plans, but Sarbanes-Oxley now requires that they be clearer to shareholders. *See* Public Company Accounting Reform and Investor Protection Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

[128] *See* 109TH CONG., EXECUTIVE COMPENSATION, *supra* note 20, at 6.

[129] *See id.* at 27.

[130] I.R.C. § 162(m); *see also* 107TH CONG., EXECUTIVE COMPENSATION, *supra* note 103, at 28–29. This assumes that the compensation amount the executive will receive from the stock option grant is not contingent on her attaining a performance goal. *See* H.R. REP. NO. 103-111, at 648–49 (1993).

[131] *See* discussion *supra* pp. 400–06. This exception to the certification requirement does not apply to stock option grants that use an exercise price below the fair market value of the stock at the time of the grant or to stock option grants that protect the executive from decreases in the value of the stock (such as through repricing); *see also* 109TH CONG., EXECUTIVE COMPENSATION, *supra* note 20, at 40.

[132] *See* SEN. COMM. R., *Revenue Reconciliation Act of 1993*, § 13211. Restricted stock is not included in the performance-based exception for stock appreciation rights because the executive may receive compensation even if the stock price declines or remains the same. Therefore, the law considers a grant of restricted stock to be cash compensation. 107TH CONG., EXECUTIVE COMPENSATION, *supra* note 103, at 29.

party or an objective formula determine the amount of compensation with knowledge of the relevant performance results is not required for stock options or stock appreciation rights.[133]

a. Shareholder Involvement

Presumably Congress was attempting to garner shareholder participation through the enactment of § 162(m).[134] While shareholder approval of performance-based compensation, including a grant of stock options, is usually required, that is not the case for the compensation of each executive. Rather, shareholders approve the stock option plan as a whole for all executives covered under the plan.[135] This allows corporations some degree of flexibility to award stock options without seeking shareholder approval every time.[136] However, it also, prevents shareholders from approving each executive's compensation package individually, even those executives hired after the shareholders approve the plan. In addition, the range of possible stock option grants under the plan may be so large that it may be difficult to determine from the plan the amount of stock options the corporation will pay an executive. Furthermore, some research suggests that increasing shareholder access to

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133 *See* 107TH CONG., EXECUTIVE COMPENSATION, *supra* note 103, at 28.

134 The SEC made multiple attempts to increase shareholder regulation of excessive compensation amounts by making those amounts more clear to shareholders. *See Corporate Law Symposium*, *supra* note 127, at 770–71. As the Director of the Division of Corporate Finance at the SEC noted, the compensation sections of proxy statements were "wholly unintelligible." *Id.* at 770. Once, someone gave several institutional investor analysts a proxy statement to see if they could discern the amount of compensation the executive were to receive. Each analyst came up with a different amount and the differences between the estimated numbers were vast. *Id.* at 771.

In 1992, despite the adoption of new disclosure rules in proxy statements, executive compensation amounts increased. Mark J. Loewenstein, *The SEC and the Future of Corporate Governance*, 45 ALA. L. REV. 783, 807–08 (1994). The new rules coincided with the enactment of § 162(m), under which compensation amounts increased through stock options grants. *See* Press Release, SEC, SEC Votes to Adopt Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters (July 26, 2006), http://www.sec.gov/news/press/2006/2006-123.htm.

After the public outrage from the Enron, WorldCom, and Tyco International corporate scandals, Congress enacted the Sarbanes-Oxley Act, which imposed even higher disclosure rules for executive compensation. *See* Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745 (2002). In addition, the Federal Accounting Standards Board revised its rules in 2005 to require corporations to list executive stock options as an expense on their financial statements. *See* FIN. ACCOUNTING STANDARDS BD., FIN. ACCOUNTING FOUND., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 123: ACCOUNTING FOR STOCK-BASED COMPENSATION (1995). This may make stock options less attractive to corporations because it will lower their stated earnings.

135 *See* SEN. COMM. R., *Revenue Reconciliation Act of 1993*, § 13211.

136 Directors may retain discretion for the precise number of options that they grant to an executive as long as it is less than the maximum number that shareholders have approved. *See* Treas. Reg. § 1.162-27(e)(2)(vi)(A) (1996).

proxy statements has not resulted in a change in shareholder proposals relating to executive compensation.[137]

Shareholders exhibit an interesting dynamic. The two basic types of shareholders, individual and institutional, may have very different motives and perspectives.[138] Individual shareholders rarely have any power in influencing corporate action and appear more likely than institutional shareholders to challenge executive compensation as a result of information contained in proxy statements.[139] Individual shareholders may also bring actions against corporations as derivative suits claiming a breach of fiduciary duty by the board of directors or that compensation amounts are a waste of corporate assets.[140]

Institutional investors may fear objecting to an executive compensation package because the stock market might react to a public objection reducing the stock price, and an objection may damage the investor's relationships with the corporation's management.[141] Therefore, they would likely prefer to object behind closed doors rather than through a shareholder vote.[142] Additionally, because the amount of executive compensation is not enough to affect the institutional investor's overall portfolio value, institutional investors are more likely to overlook excessive compensation.[143] Institutional investors, however, are concerned that executives are able to insulate their compensation amounts while rank and file employees and shareholders are subject to risk.[144]

The shareholder approval requirement is further frustrated because shareholders are often apathetic when it comes to reviewing proxy disclosures and voting. With respect to disclosure requirements recently enacted by the SEC, one commentator noted, "If a shareholder is rationally apathetic when considering an issue concerning executive compen-

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137 Lori B. Marino, Comment, *Executive Compensation and the Misplaced Emphasis on Increasing Shareholder Access to the Proxy*, 147 U. PA. L. REV. 1205, 1227–30 (1999).

138 *See CEO Compensation in the Post-Enron Era: Hearing Before the S. Comm. on Commerce, Science and Transportation*, 108th Cong. 25 (2003) [hereinafter *CEO Compensation Hearings*] (statement of Sean Harrigan, President of the California Public Employees' Retirement System) (stating that as an institutional investor, "[i]t is absolutely unconscionable to see that CEO pay has swollen to 400 times that of the average production worker.").

139 *See* Marino, *supra* note 137, at 1230–31.

140 *See* 18B AM. JUR. 2D *Corporations* § 1460 (2007); *see, e.g.*, *In re* Walt Disney Co., 907 A.2d 693, 745–49 (Del. 2005); Gagliardi v. Tirfoods International, Inc., 683 A.2d 1049, 1052 (Del. 1996); Grobow v. Perot, 539 A.2d 180, 187 (Del. 1988); *see also* Hillary Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456 (2004).

141 *See* Marino, *supra* note 137, at 1234.

142 *CEO Compensation Hearings*, *supra* note 138, at 4 (statement of Peter C. Clapman, Senior Vice President and Chief Counsel of Corporate Governance, TIAA-CREF) (stating that TIAA-CREF, as a large financial services company and proponent for shareholder rights and corporate governance, prefers "quiet diplomacy," though it would file shareholder resolutions if necessary).

143 Marino, *supra* note 137, at 1235.

144 *Id.*

sation, then the details required by the disclosure regulations will not benefit that shareholder because the shareholder will not take the time to become informed."[145] Shareholder action on executive compensation is also hindered by the free rider syndrome, where shareholders assume the other shareholders will become informed and take appropriate action so the free riders ignore the issues.[146] As a result, no one becomes informed and no action is ever taken.[147]

Although the shareholder approval requirement has been ineffective, shareholders often have no other means of objecting to compensation amounts. Because courts have been unresponsive to court actions brought by shareholders objecting to compensation levels,[148] it is important to give shareholders some ability to bless or reject a compensation package. Section 162(m) should be repealed, but Congress should consider retaining shareholder approval for the deductibility of compensation packages. While shareholders may not always take advantage of their ability to object, if the disclosure of compensation packages were less opaque, shareholders might be more likely to participate in executive compensation.

b. Board of Directors

The performance-based exception in § 162(m) also requires approval by an independent board of directors. The board of directors is not an effective check on the level of executive compensation because directors are often beholden to management.[149] Several commentators have noted that the independent board requirement has not resulted in lower levels of executive compensation.[150] Boards passively "rubber-stamp" the decisions of executives.[151] Further, directors often act more like employees of executive management than representatives of shareholders.[152]

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145 Nathan Knutt, Note, *Executive Compensation Regulation: Corporate America, Heal Thyself*, 47 ARIZ. L. REV. 493, 503 (2005).

146 *Id.* at 504.

147 *Id.*

148 *See, e.g.*, *In re* Walt Disney Co., 906 A.2d 27 (Del. 2006).

149 Kreinberg, *supra* note 34, at 162.

150 Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 128 (1996); *see also* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 26–28 (2004); MYLES L. MACE, DIRECTORS: MYTH AND REALITY 13–16, 178–79, 185–86 (1971) (finding that boards of directors usually serve an advisory role rather than a decision making one and thus do not truly govern the business affairs of corporations).

151 *Id.*

152 *See* Elson, *supra* note 150, at 133.

"Rubber stamp" was the exact term the Joint Committee on Taxation used to generally describe the actions of Enron's Compensation Committee of the Board of Directors.[153] The compensation committee generally rubber-stamped compensation that seemed consistent with that of executives at other companies rather than basing their decision on the worth of the executive to Enron.[154] Enron's compensation committee's evaluation of reasonable compensation, based on what similarly situated employees make at similarly situated corporations, is entirely consistent with the determination of reasonable compensation under § 162. Also, negotiations between the directors and the executive were insufficient when setting compensation levels for the executive.[155]

Because the CEO, in effect, hires compensation consultants, those consultants have an incentive to justify the amount the executive wants for compensation so that the executive will recommend the consultant to other CEOs.[156] Lucian Bebchuk and Jesse Fried in their book, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, argue that the CEO has so much influence over the board of directors that the board cannot be a sufficient check on the CEO.[157] They also argue that because of this influence, CEOs can essentially set their own compensation.[158] Their position is consistent with what transpired at Enron. The limitations set out in § 162(m) do not appear to have any effect on preventing this type of abuse.

2. *The Effect of § 162(m) on Excessive Executive Compensation*

One of two things happened to executive salaries after the enactment of § 162(m): either corporations forwent the deduction; or the compensation of executives, excluding stock options, was set at $1 million.[159] Many corporations decided that the limitations interfered with their ability to set what they deemed to be the appropriate level of compensation and, as a result, decided that it was in the best long-term interests of the corporation to forgo the deduction.[160] This result in turn

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153 STAFF OF J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS: JCS-3-03, at 19, 36 (Comm. Print 2003) [hereinafter REPORT OF INVESTIGATION OF ENRON CORPORATION].

154 *Id.* at 36.

155 *Id.*

156 *Id.* at 38.

157 *See* BEBCHUK & FRIED, *supra* note 150, at 26–28.

158 *See id.* at 38–40.

159 *See* 109TH CONG., EXECUTIVE COMPENSATION, *supra* note 20, at 6–7.

160 *See id.*; *see also Corporate Law Symposium*, *supra* note 127, at 781–82 (stating that a number of companies decided to forgo the deduction, some reportedly because the limitation imposed by § 162(m) would interfere with their ability to act in the best short- and long-term interests of their shareholders); Steven Balsam & Qin Jennifer Yin, *Explaining Firm Willingness to Forfeit Tax Deductions Under Internal Revenue Code Section 162(m): The Million-*

cost shareholders more than the compensation alone would have cost prior to § 162(m). Compensation was still based on the market, and now corporations were not entitled to a deduction. This result was contrary to the intention of Congress, to protect shareholders and conversely resulted in the opposite effect, a greater expense to shareholders. In the other cases, $1 million now became the standard for executive salaries.[161] Corporations, in an attempt to comply with § 162(m), set salary at or below $1 million and instead offered other types of compensation not limited by § 162(m), such as stock options.[162]

Stock options are not optimal for tying an executive's performance to compensation because they do not truly align the interests of shareholders and executives. Executives are more interested in a short-term increase in the stock price, allowing them to sell their exercised stock options at a profit as early as possible. Shareholders, in contrast, are generally interested in the corporation's long-term growth.[163] This was particularly evident in the Enron case.[164] As one commentator noted, "Given the harm that stock options can do to investor interests, management's use of stock options and stock compensation are a sign that managers are being disloyal to investors, especially when management chooses not to record the cost of the options in its income statements given to investors."[165]

Enron in fact had a pay-for-performance compensation philosophy.[166] Enron's compensation for its 200 highest paid employees in 2000 was $1.4 billion—$1.2 billion of which was attributable to stock options and restricted stock.[167] Enron's main form of compensation was stock-based compensation such as stock options, restricted stock and phantom stock.[168]

Dollar Cap, 24 J. ACCT. & PUB. POL'Y 300, 321 (2005) (finding that almost forty percent of affected corporations forfeited deductions rather than comply with the $1 million cap).

161 *See* Scott DeCarlo, *What the Boss Makes*, FORBES.COM, Apr. 20, 2006, http://www.forbes.com/2006/04/20/ceo-pay-options-cz_sw_0420ceopay.html (stating that in 2005 Richard D. Fairbank, CEO of Capital One Financial, had no base salary, but had a total compensation amount of $249.3 million, Terry S. Semel, CEO of Yahoo!, made $600,000 in base salary with a total compensation amount of $231 million, and Richard S. Fuld Jr., CEO of Lehman Brothers Holdings, made $750,000 in base salary with a total compensation amount of $123 million).

162 *See* 109TH CONG., EXECUTIVE COMPENSATION, *supra* note 20, at 7; *see also* Balsam & Yin, *supra* note 160, at 320–21.

163 *See* REPORT OF INVESTIGATION OF ENRON CORPORATION, *supra* note 153, at 41.

164 *Id.*

165 Calvin H. Johnson, *The Disloyalty of Stock and Stock Option Compensation*, 11 CONN. INS. L.J. 133, 134 (2005).

166 *See* REPORT OF INVESTIGATION OF ENRON CORPORATION, *supra* note 153, at 13.

167 *See id.* at 36.

168 *See id.* at 14.

In 2003, the Joint Committee on Taxation prepared a 700-page report on Enron's compensation practices.[169] In this report, the Committee noted that the $1 million limitation imposed by § 162(m) had little effect on the company.[170] The Committee went on to state that the limitation of § 162(m) had been included to address the excessive compensation amounts that some executives were receiving.[171] Furthermore, the Committee recommended removing § 162(m) altogether.[172] As the Committee noted, "[T]he experience with Enron indicates that the limitation is not effective in achieving its purposes. Taxpayers may choose to pay nondeductible compensation, and accept the potential adverse tax consequences."[173]

Because stock options are considered performance-based and therefore excluded from the deduction limitations of § 162(m), many corporations began granting stock options as the major component of executive compensation.[174] Stock options had been granted prior to the enactment of § 162(m), but were generally a small part of a compensation package.[175] However, this changed following the enactment of § 162(m) in 1993. After the enactment of § 162(m) there was an increase in stock option grants, followed by unanticipated massive growth in the stock market.[176] The stock market experienced record growth in the late 1990s. As a result of this combination of massive increase of stock options and the significant growth of the stock market, executives began making record amounts of compensation. Some commentators have argued that the growth of stock options was behind the stock market bubble and its collapse.[177] Less aggressive arguments have been that the increase in executive compensation was "the first result of the increase in incentive compensation in the form of stock options."[178] These stock options were implemented by corporate boards in response to demands that executive compensation be more closely linked to shareholder returns.[179]

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169 *Id.*

170 *See id.* at 42.

171 *See Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations: Hearing Before the S. Comm. on Finance*, 108TH CONG., 36 (2003) (written testimony of Lindy Paull, Chief of Staff, Joint Comm. on Taxation).

172 *See* REPORT OF INVESTIGATION OF ENRON CORPORATION, *supra* note 153, at 20.

173 *See id.* at 43.

174 *See* 109TH CONG., EXECUTIVE COMPENSATION, *supra* note 20, at 6.

175 *See Oversight Hearing*, *supra* note 49, at 101.

176 *See id.*

177 *See* Roberta S. Karmel, *Realizing the Dream of William O. Douglas—The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 104 (2005).

178 Loewenstein, *The Conundrum*, *supra* note 12, at 8.

179 *See id.*

In response to the limitations of § 162, executives demanded pay comparable to that which similarly situated executives were receiving. Executives argued that stock options were riskier than fixed cash salaries and bonuses because there is no guarantee that the stock price will rise. Consequently, they demanded stock options equaling a larger value than they would have received had they simply been paid outright in salary.[180] As a result of the growth of stock options and the concurrent growth of the stock market, the comparable amounts grew dramatically.[181] However, because of the nature of the stock market in the late 1990s, it is unclear whether the argument that stock options were risky actually had merit.[182]

After the passage of § 162(m), compensation paid to executives grew at a "29 percent faster rate in the first year after the law took effect than in the previous 14 years that the service had collected comparable information."[183] On average, stock options made up 3 to 5% of a corporation's stock in 1994.[184] In 2002 this percentage tripled to 12 to 15%.[185] Additionally, 79% of the increase in median compensation paid to chief executive officers from 1992 to 2000 was primarily due to the increased use of stock options.[186] In 1992, stock options were "27 percent of median CEO compensation, whereas by 2000 options were 60 percent of median compensation."[187] Executives who were now paid in "performance-based" stock options rather than cash demanded a higher amount of stock options than the value of the cash they would have received, in order to compensate them for the possible risk of stock decline.[188] The cash the executives would have received was guaranteed,

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180 *See* 109TH CONG., EXECUTIVE COMPENSATION, *supra* note 20, at 6; *see also* CONFERENCE BD. COMM'N ON PUB. TRUST AND PRIVATE ENTER., FINDINGS AND RECOMMENDATIONS, PART 1: EXECUTIVE COMPENSATION 4 (2002) [hereinafter CONFERENCE BD. COMM'N] (stating that factors including the speculative nature of stock options, which are undervalued by executives and therefore necessitate higher levels of stock option grants, led to a "perfect storm" to create an environment "ripe for abuse").

181 *See* AFL-CIO, *2007 Executive Paywatch*, http://www.aflcio.org/corporatewatch/paywatch/ (last visited Feb. 18, 2008) (stating that the average CEO in an S&P 500 company made $14.78 million in 2006); *see also* Murphy, *supra* note 30, at 847 (stating that median pay of a CEO in 1992 was $2.3 million); *News in Brief*, *supra* note 10, at 1; Soto & Meacham, *supra* note 7; *You Bought, They Sold*, *supra* note 7, at 64; Sahadi, *supra* note 10, at 1.

182 *See Corporate Law Symposium*, *supra* note 127, at 805 (stating that, when offered $1 cash for each option, executives never agreed to the exchange, despite hearing the argument that their options were essentially worthless).

183 *See* Stabile, *supra* note 93, at 89 (citing David Cay Johnston, *Executive Pay Increases at a Much Faster Rate than Corporate Revenues and Profits*, N.Y. TIMES, Sept. 2, 1997, at D4).

184 *See Oversight Hearing*, *supra* note 49, at 3.

185 *See id.*

186 CONFERENCE BD. COMM'N, *supra* note 180, at 4.

187 *See id.*

188 *See Corporate Law Symposium*, *supra* note 127, at 739.

but stock options can run the risk of being worth little or nothing by the time they can be exercised. Due to the growth of the use of stock options, executives began receiving huge amounts of compensation. This high compensation rate became industry norm, leading to a higher compensation demand by executives. Therefore, while § 162(m) was supposed to rein in the excessive compensation, it only served to further exacerbate the problem. The state of executive compensation was better prior to enactment of § 162(m). Section 162(m) did not result in a true link between compensation and company performance because the company performance was evaluated through stock price, and stock price is not always linked to the performance of the executive or the corporation.[189] This is particularly true when executives are motivated to manipulate stock prices to increase their compensation. In addition, § 162(m) ultimately resulted in more compensation being paid. Executives now receive unprecedented amounts in compensation at the expense of shareholders.

Moreover, because in the unprecedented bull market stock prices were going up without any real connection to the performance of the company, the dramatic increase in compensation had very little connection to the performance of the company.[190] One commentator hinted that he suspected the conversion of cash compensation to stock options as a result of § 162(m) was intentional. He stated that, "the explosion of option grants is evidence that the measure backfired (or was never intended to work). A more charitable reading is that § 162(m) was *supposed* to promote options (as well as other "performance compensation" such as bonuses based on accounting earnings).[191]

In fact, because § 162(m) does not require an evaluation of the performance of the company as compared to, or rather indexed to, the major stock indexes or industry indexes, it is entirely possible (and often the case) that an executive will be compensated and rewarded simply because of the growth of the economy. However, these increases in compensation are not due to inflation, but rather to the growth of the stock market as a whole. Because a company's stock (and, by implication, options in that stock) can become more valuable as a result of growth in the stock market, the executive can profit even if he is doing a poor job.

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[189] CONFERENCE BD. COMM'N, *supra* note 180, at 4.

[190] *See id.* (stating that the growth of the stock market led to "massive, unanticipated gains from options unrelated to management's operating performance"); *see also* BEBCHUK & FRIED, *supra* note 150, at 190 (suggesting taking into account market fluctuations when compensating an executive with options, as a way to better gauge performance of the executive); *Corporate Law Symposium*, *supra* note 127, at 739.

[191] David M. Schizer, *Executives and Hedging, The Fragile Legal Foundation of Incentive Compatibility*, 100 COLUM. L. REV. 440, 468 (2000).

In the alternative, an executive's options can become less valuable when the stock market declines, even though the executive is performing well.

3. *Conclusions on the Effectiveness of § 162(m)*

Section 162(m) was not effective in curtailing excessive executive salaries. On the contrary, § 162(m) resulted in higher salaries because it allowed corporations to avoid the problem merely by shifting the form of compensation from cash to stock options.[192] Because stock options are riskier than cash, and comparatively easy to hide, compensation amounts increased dramatically and shareholders bore the increased costs in the form of lost deductions. Moreover, § 162(m) did not result in linking executive compensation to the performance of either the executive or the corporation. A corporation's stock prices fluctuate independent of the performance of its executive or of the corporation itself.[193] In addition, the executive may also be reaping the benefit of a predecessor's efforts.

Another difficulty with paying an executive in stock options is that it may not always bring out the best in the executive or produce the best results for the corporation. As we saw with Enron, stock options can actually result in executives exploiting the corporation and misstating (or inflating) earnings in order to increase the value of the options.[194] The Joint Committee on Taxation noted that, because executive pay is adversely affected during times of poor corporate performance, executives may be inclined to manipulate earnings to provide a smoother earnings pattern.[195]

Tying executive compensation to the stock price of the corporation through stock options incentivizes executives to see the stock price of the corporation rise even if it is not in the best interests of the corporation. Executives may hope to convert their options to cash as quickly as possible to maximize any possible compensation while reducing the risk they

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[192] *See* 109TH CONG., EXECUTIVE COMPENSATION, *supra* note 20, at 2, 7.

[193] *See* Iman Anabtawi, *Explaining Pay Without Performance: The Tournament Alternative*, 54 EMORY L.J. 1557, 1567–68 (raising the issue that "broad macroeconomic factors," such as fluctuations in interest rates and other industry related shocks may affect stock prices independently of the actions of an executive).

[194] *See* Karmel, *supra* note 177, at 99–100 (stating that Congress itself was "so corrupted by campaign contributions that it could not have blown the whistle on Enron."). Professor Karmel further argues that while executive stock options were one cause of the stock market bubble, Congress further exacerbated the problem by stopping the Financial Accounting Standards Board (FASB) from treating stock options as corporate expenses. *See id.*
In 2005 the FASB amended FASB Statements No. 123 and 95, requiring corporations to report the grant of stock options as an expense on their financial statements. *See Oversight Hearing*, *supra* note 49 (written testimony of Donald P. Delves, President, The Delves Group) (stating that,"[w]ith no expense, these 'free' options were liberally given out to executives and employees (although mostly to executives) with very little rigorous thought about the effect on shareholder value and shareholder wealth.").

[195] *See* 109TH CONG., EXECUTIVE COMPENSATION, *supra* note 20, at 8.

face from any market declines. This encourages executives to seek short-term stock price increases and encourages some executives to engage in fraudulent or inappropriate behavior. Shareholders, on the other hand, would often prefer to see long-term growth in the corporation rather than short-term price increases. Congress presumably did not anticipate this divergence of interests in 1993 but that divergence has prevented § 162(m) from effectively curtailing compensation and has contributed to recent abhorrent corporate behavior.

Section 162(m) also caused many corporations to forgo the deduction for compensation.[196] It was presumably the intention of Congress to change corporate behavior by limiting deductions for compensation.[197] Instead, many corporations opted to forgo the deduction at a greater expense to the very shareholders Congress was trying to protect. While corporations may have considered the impact of losing the deduction for compensation paid as a result of § 162(m), other concerns—such as pressure from shareholder groups, the transaction costs that would be incurred in changing an employment contract, the amount of compensation being paid to similarly-situated executives at similar corporations, insider ownership, and the tax cost of losing the deduction—affect whether a corporation decides to forgo the deduction or limit the executive's compensation.[198] The Committee on Joint Taxation has stated that § 162(m) has not resulted in a slowing of the growth of executive compensation.[199] Furthermore, § 162(m) has resulted in corporations planning their executive compensation packages strategically to avoid the impact of the deduction limitation. The growth of stock options is one example of this. It is unclear that this problem with § 162(m) has a solution—any amendment would likely be subject to similar kinds of avoidance strategies.

Deferred compensation plans that avoid the application of § 162(m) are another avoidance tactic corporations have developed.[200] Instead of heeding the advice of the Joint Committee on Taxation and removing § 162(m) altogether, Congress attempted to extend the reach of § 162(m) to deferred compensation, applying the $1 million limitation to former as well as current executives.[201] The decision to propose an amendment to

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[196] *See id.*; *see also* Balsam & Yin, *supra* note 160, at 321 (finding that forty percent of affected corporations forfeit deductions as a result of the cap imposed by § 162(m)).

[197] *See* Meegan Reilly, *Former Treasury Official Discusses Executive Compensation Cap*, 62 TAX NOTES 747 (1994) (discussing statement of Catherine Creech, former Treasury benefits tax counsel, that § 162(m) was not intended as a revenue-raising provision but rather as a "behavior shaping provision.").

[198] *See* 109TH CONG., EXECUTIVE COMPENSATION, *supra* note 20, at 6.

[199] *See id.*

[200] *See id.* at 9, 29.

[201] *See* STAFF OF J. COMM. ON TAXATION, 110TH CONG., DESCRIPTION OF THE CHAIRMAN'S MODIFICATION OF THE PROVISIONS OF THE "SMALL BUSINESS AND WORK OPPORTUNITY ACT OF 2007," at 25 (Comm. Print 2007).

§ 162(m) to extend its reach to deferred compensation may have been based on the Joint Committee on Taxation's recommendation that Congress should consider modifying the definition of a covered employee to include prior employees as well.[202] Again, if this proposal is enacted it will likely have one of two consequences—either companies will pay the market rate for talented executives and will not be permitted a deduction for the compensation expense, or they will invent another way to circumvent § 162(m). It is easy to imagine how partnerships or other entities could be used to circumvent § 162(m). Most corporations are currently so unconcerned with § 162(m) that it remains unclear whether corporations will seek alternatives rather than simply forgoing the deductions. Because § 162(m) interferes with a corporation's ability to recruit talented executives by limiting the base compensation, many corporations have decided that it is in their best interests simply to disregard the provision altogether and to hire the best person for the job.

Another problem with § 162(m) is that Congress has declared what it deems a fair salary for an executive: $1 million. Courts have held that it is not the amount of compensation that renders it excessive but rather the terms and factors surrounding the compensation.[203] Congress was short-sighted when it set the cap at $1 million in 1993 without allowing for adjustments for inflation. Simple principles of time-value-of-money and inflation make clear that $1 million today is not as valuable as it was nearly fifteen years ago. Although courts say that the amount of compensation cannot by itself render the compensation unreasonable, Congress has deemed non-performance-based compensation of more than $1 million unreasonable.[204]

Moreover, § 162(m) does not distinguish between corporations of different sizes or between different levels of executive work. This is true despite the fact that the complexity and scale of a corporation's business, and thus the requirements of the executive's job, vary widely.

Presumably, § 162(m) was enacted to protect shareholder returns. Congress did not, however, endeavor to offer the same protections with regard to compensation paid to other forms of ownership, such as partners in partnerships. Executives at private equity funds have received extremely large payments, well in excess of the $1 million cap that would not have been allowed if they had been subject to § 162(m), yet these compensation amounts are only subject to the reasonable compen-

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[202] *See* 109TH CONG., EXECUTIVE COMPENSATION, *supra* note 20, at 6.

[203] *See* Botany Worsted Mills v. United States, 278 U.S. 282, 292 (1929); Gray & Co. v. United States, 35 F.2d 968, 975 (Ct. Cl. 1929).

[204] *See Gray & Co.*, 35 F.2d at 973.

sation limits of § 162.[205] In addition, the amounts paid to movie stars, recording artists, sports figures, and other highly-paid professionals are not subject to § 162(m). Many of these compensation packages are paid by corporations but are not subject to the limitations of § 162(m). Section 162(m) by its terms only applies to the CEO and the four highest paid officers of the corporation. Therefore, compensation amounts paid to others in the corporation are not subject to scrutiny under § 162(m), even though they may be in excess of $1 million. If Congress was truly concerned about shareholder returns and preventing excessive compensation, it should not limit § 162(m) to certain executives who work at corporations but rather should apply it to all compensation at all businesses.[206]

Section 162(m) changed the form in which compensation is paid and made it more difficult for shareholders to determine how much executive salaries actually were. In addition, some commentators have noted that a corporation's profits are actually lowered as a result of switching from cash compensation to performance-based compensation such as stock options.[207]

Section 162(m) also resulted in an incentive for executives to engage in risky or illegal behavior to maximize short-term returns. Because executive compensation was tied to stock prices, executives had a motive to try to increase stock price to allow the executives to cash out their stock options at a profit. Because the executives did not represent

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[205] *See, e.g.*, Andrew Ross Sorkin & Peter Edmonston, *A Titan of Private Equity May Go Public*, N.Y. TIMES, Mar. 17, 2007, at C1 (discussing the possibility of Blackstone Group, a private equity firm, going public and stating that "[a]s a public company, Blackstone would be subject to the same kind of scrutiny that it has tried to avoid. The compensation and perks of its executives, some of whom are routinely paid more than $50 million a year, would also have to be disclosed. Mr. Schwarzman, who owns as much as 40 percent of the firm, is said to regularly pay himself in excess of $300 million annually, according to people close to the firm.").

Payments to executives are often not taxed as compensation and instead taxed at capital gains rates as partnership distributions. *See* Phil Mattingly & Richard Rubin, *HR 3996—Tax Increase Prevention Act of 2007*, CQ BILLANALYSIS, Dec. 22, 2007.

[206] There is a growing consensus that allowing partnerships, particularly private equity funds, to distribute to their executives what is presumably compensation taxed at capital gains' rates rather than income rates is inequitable. *See* Susan Beck, *Securities and Corporate Governance: A Practice Focus No Eyes on Them Clever Lawyering Lets Newly Public Firm Escape Taxes and SEC Scrutiny*, LEGAL TIMES, Nov. 19, 2007, at 28; Mattingly & Rubin, *supra* note 205. Although fixing this disparity would result in executives paying ordinary income tax, it would still not put a cap on the distributions the partnerships can make subject to a deduction. *See* Susan Beck, *Securities and Corporate Governance: A Practice Focus No Eyes on Them Clever Lawyering Lets Newly Public Firm Escape Taxes and SEC Scrutiny*, LEGAL TIMES, Nov. 19, 2007, at 28; Mattingly & Rubin, *supra* note 205.

[207] *See* 109TH CONG., EXECUTIVE COMPENSATION, *supra* note 20, at 8; *see also* Marcel Kahan, *The Limited Significance of Norms for Corporate Governance*, 149 U. PA. L. REV. 1869, 1888 (2001) (discussing the rising use of stock options in executive compensation packages).

true ownership interests in the corporation and instead were employees, they could have been motivated to act in the interests of short-term benefits to realize their compensation rather than what would be in the best interests of the corporation in the long term. This resulted in many executives taking unnecessary risks and engaging in unethical and sometimes illegal activities to maximize short-term profits to ensure a sizeable compensation amount.

C. SECTION 280G[208]

1. *Golden Parachute Payments and the Corporate Motivation for Making These Payments*

Golden parachute payments are typically given as part of an employment contract when an executive is hired.[209] The thought behind the contract provision is that an executive would not take the job without some guarantee that, even in the event of a merger or sale, the executive will be "taken care of" financially. Corporations thus began giving executives golden parachute agreements because the added security of payments in the event of a change in ownership of the corporation helped to recruit executives.[210] These payments also improved executive retention rates, increasing the "stability and continuity of management."[211] Further, golden parachute payments also help ensure that management of corporations remains objective when evaluating a change in control because the executives do not have to worry about the financial ramifications of losing their jobs once new owners take control.[212] Of course, objectivity may not be the result in many cases where an executive stands to reap a significant financial benefit as a result of the change in control. Finally, parachute payments may discourage hostile takeovers by making the proposed purchase or merger too expensive to complete after considering the golden parachute payments.[213]

Section 280G was enacted in response to the huge golden parachute payments executives were receiving in the flurry of mergers in the 1980s.[214] The complaints were that golden parachute payments de-

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208 Readers not familiar with the Internal Revenue Code should note the distinction between § 280G (discussed here) and § 280(g) (repealed in 1986).

209 Ryan Miske, Note, *Can't Cap Corporate Greed: Unintended Consequences of Trying to Control Executive Compensation Through the Tax Code*, 88 MINN. L. REV. 1673, 1680–81 (2004).

210 *See* Henry Johnson, *Those "Golden Parachute" Agreements: The Taxman Cuts the Ripcord*, 10 DEL. J. CORP. L. 45, 48 (1985).

211 *See id.*

212 *See id.* at 49.

213 *See id.*

214 *See* STAFF OF J. COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 199 (Comm. Print 1984).

creased stock value, discouraged buyers from purchasing the company because they knew they would have to make huge payments to executives, and perhaps encouraged management to cause takeovers to trigger the huge payments that would result after a change of control.[215] All of these scenarios disadvantaged shareholders, and Congress reacted by enacting I.R.C. §§ 280G and 4999. Section 280G ensures that a corporation cannot deduct a golden parachute payment, and § 4999 ensures that an executive pays an additional 20% excise tax on the excess parachute payment.[216] Both of these provisions were intended to limit the amount of golden parachute payments offered and to allow for some income and wealth distribution for the large amount the executive was receiving.[217]

Section 280G was intended to prevent or slow golden parachute payments.[218] Congress was concerned that corporations were including golden parachute payments in employment contracts with executives as part of a strategic plan to make hostile takeovers unattractive to interested buyers.[219] Congress thought that because these provisions "hindered acquisition activity in the marketplace," they should be discouraged.[220] Section 280G was enacted to discourage these contract provisions which might reduce the amounts paid to the corporation's shareholders in the event of a change in control.[221]

The tax code allows some portion of a golden parachute payment to be deductible, but any parachute payment amount over the executive's average salary is considered excessive and will not be deductible.[222] The executive will also pay a twenty percent excise tax on the parachute payment.[223] A golden parachute payment to an executive is considered excessive if the payment to the executive is more than three times his average salary.[224] An executive's average salary is the average of the last five years' compensation.[225] Payments under a qualified retirement

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215 *See id.*

216 I.R.C. §§ 280G(a), 4999(a) (West 2007).

217 *See* I.R.C. §§ 280G, 4999.

218 *See* STAFF OF J. COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 199 (Comm. Print 1984).

219 *See id.*

220 *See id.*

221 *See id.* at 199–200.

222 *See* I.R.C. §§ 280G(a), 280G(b)(1) (providing that the excess parachute payment will not be allowed as a deduction and defining excess parachute payment as the amount in excess of the (still deductible) base amount).

223 *See* I.R.C. §§ 280G(a)(5), 4999(a). Section 280G does not apply to corporations that qualify as small business corporations.

224 *See* I.R.C. §§ 280G(b)(2)(A)(iii), 280G(b)(3). The term "average salary" in this article refers to the base amount as defined in § 280G(b)(3).

225 *See* I.R.C. §§ 280G(b)(3)(A), 280G(d)(2). Section 162(m) was designed to work in conjunction with § 280G by providing that the deduction limitation of § 162(m) will be reduced by excess parachute payments under § 280G that are not deductible by the corporation. *See* I.R.C. § 162(m)(4)(F).

plan and payments for services rendered on or after the date of the change in control are not considered golden parachute payments.[226] The provisions apply to any employee or other person (as specified in the regulations) who performs services for the corporation and is an officer, shareholder, or other highly-compensated individual.[227] A highly-compensated individual is any person who is among the highest one percent of the individuals performing services for the corporation or the 250 highest paid individuals of the corporation (including corporations in the affiliated group).[228]

Section 280G only applies when a change in control has occurred. If a corporation wants to pay an executive an enormous severance package independent of a change in control, the limitations of § 280G do not apply. Shareholders have recently objected to the $210 million payment received by Robert Nardelli after he resigned from Home Depot in 2007 ($20 million of which was a severance payment) and the $21 million severance payment received by Carly Fiorina from Hewlett Packard.[229] These payments, while very large, will not be subject to the deduction limitations of § 280G or the twenty percent excise tax under § 4999, although the deductible amount will be limited to the extent the payment runs afoul of §§ 162 and 162(m).[230] Therefore, if a large severance package is paid out in stock options, for example, it likely will be deductible regardless of amount, because stock options are performance-based and the payment was not made in connection to a change in control.

The deduction limitations imposed by § 280G and the excise tax under § 4999 only apply if a change in control occurs and only if the payment to the executive was contingent on a change in control.[231] A change in control takes place when effective control of the corporation has changed hands, the ownership of the corporation has changed or a substantial portion the underlying assets of the corporation has changed ownership.[232] The penalties under §§ 280G and 4999 can be avoided if

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226 *See* 107TH CONG., EXECUTIVE COMPENSATION, *supra* note 103, at 30.

227 *See* I.R.C. § 280G(c).

228 *See id.*

229 *See* Ylan Q. Mui, *Home Depot's CEO Resigns, and His Hefty Payout Raises Ire*, WASH. POST, Jan. 4, 2007, at D1.

230 Section 280G would not apply because the payment does not result from a change in control. *See* I.R.C. § 280G(b)(2)(A). The $1,000,000 limitation under § 162(m) would apply to the payment because it exceeds the amount limitation and presumably is not tied to the executive's attainment of a certain performance goal, namely being terminated. *See* I.R.C. § 162(m); *see also* Rev. Rul. 2008-13 (further clarifying that compensation will not be considered "performance-based" under § 162(m), even if the compensation is paid upon the attainment of the performance goal, if the plan agreement or contract provides for payment of compensation to an executive upon the attainment of a performance goal or for (1) termination without "cause" or for "good reason" or (2) voluntary retirement).

231 *See* I.R.C. § 280G(b)(2)(A)(i).

232 *See id.*

the taxpayer can prove by clear and convincing evidence that the compensation is reasonable compensation for personal services actually rendered before the change in control.[233]

The enactment of §§ 280G and 4999 resulted in executives often requiring that the company pay the excise tax to the IRS on behalf of the executive if they are to be paid a golden parachute payment.[234] Because of the twenty percent excise tax for the executive and the twenty percent tax that arises on the tax payment, and so on, the parachute payment ultimately costs the company and the shareholders $1,499,988 rather than just $1 million.[235]

One author has posited that the limitations on golden parachute payments has functioned essentially as a congressional blessing for corporations to pay 299% of the base amount and as a result, this is the standard in corporations in many employment contracts.[236]

2. *The Intent Behind § 280G*

The enactment of § 280G was partly motivated by a concern that golden parachute payments discouraged interested companies from proceeding with acquisitions or potential buyers from becoming interested in the first place.[237] The substantial payments to top executives would increase the acquisition cost significantly and, as a result, a potential purchaser might reconsider the purchase.[238] The Joint Committee on Taxation stated that the limitation imposed by § 280G might be "viewed as

233 *See* I.R.C. § 280G(b)(4).

234 *See CEO Compensation Hearings*, *supra* note 138, at 28 (prepared statement of Sean Harrigan, President, Board of Administration, California Public Employees' Retirement System) (noting that there "appears to be an attitude of entitlement[s]," including gross-up provisions covering executives' tax liabilities, "in the executive suite of corporate America."); STAFF OF J. COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 200 (Joint Comm. Print 1984).

235 $1,499,988 is based on the following calculation. $1,000,000 x 20% = $200,000. Gross up provisions may also include an agreement for the corporation to pay for the additional income taxes on the grossed up amount meaning that the corporation will pay 20% tax on the subsequent taxes plus 40% (assuming a hypothetical combined state and federal tax rate of 40%). $200,000 x 60% = $120,000. $120,000 x 60% = $72,000. $72,000 x 60% = $43,200. $43,200 x 60% = $25,920. $25,920 x 60% = $15,552. $15,552 x 60% = $9,331. $9,331 x 60% = $5,599. $5,599 x 60% = $3,359. $3,359 x 60% = $2016. $2,016 x 60% = $1,209. $1,209 x 60% = $726. $726 x 60% = $435. $435 x 60% = $261. $261 x 60% = $157. $157 x 60% = $94. $94 x 60% = $56. $56 x 60% = $34. $34 x 60% = $20. $20 x 60% = $12. $12 x 60% = $7. $200,000 + $120,000 + $72,000 + $43,200 +$ 25,920 + $15,552 + 9,331 + $5,599 + $3,359 + $2,016 + $1,209 + $726 + $435 + $261 + $157 + $94 + $56 + $34 + $20 + $12 + $7 = $499,988. Therefore the corporation would be paying the executive $1,000,000 plus an additional $499,988 in tax liabilities. In addition, this amount does not include the cost to shareholders of the loss of the deduction on this payment to the executive.

236 *See* Miske, *supra* note 209, at 1680 (2004).

237 *See* STAFF OF J. COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 199 (Comm. Print 1984).

238 *See id.*

indirectly favoring friendly acquisitions."[239] Presumably this is because if a purchaser is friendly, exceptions to a golden parachute payment clause could be made once the executive was given reassurance of a job after the sale.

Again, as with § 162(m), the effects of § 280G directly contradict the legislative intent of the statute, which was to protect the shareholders from excessive amounts being paid to the executives.[240] Not only will the excess payments and the gross-up[241] not be deductible to the corporation as a result of §§ 280G and 4999, but it will now cost the shareholders even more because of the additional amounts paid to executives to cover additional taxes.[242]

Executives often demand these payments before signing onto a new corporation, not only to give them security in case of a clash in corporate culture or some other unexpected situation, but also to compensate them for payments they would have received had they not been recruited away from their former employers.[243] While one cannot fault an executive for negotiating the best compensation package possible, sometimes life presents difficult choices and the risk of switching jobs is one of them. Many taxpayers wish they had a guarantee that a major life change would be risk free. However, that is not an accurate representation of reality—unless of course you are an executive with a golden parachute. Therefore, it is up to the board of directors in a true arm's length transaction to obtain executives' services at the lowest cost to the corporation. Nevertheless, if the market requires a golden parachute in order to recruit a talented executive, corporations will likely provide them regardless of the tax consequences.

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239 STAFF OF THE J. COMM. ON TAXATION, 99TH CONG., FEDERAL INCOME TAX ASPECTS OF HOSTILE TAKEOVERS AND OTHER CORPORATE MERGERS AND ACQUISITIONS 4 n.5 (Comm. Print 1985). This is an exception to the Joint Committee's statement that "the Code neither encourages nor discourages a hostile, as opposed to a friendly, acquisition." *See id.* at 4.

240 STAFF OF J. COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 200 (Joint Comm. Print 1984).

241 A "gross-up" occurs when a corporation agrees to pay taxes for an executive, which in turn gives rise to a tax payment due on the taxes the employer paid. The "gross-up" amount is the total amount that the corporation must pay to completely pay an employee's tax liability. For example, if a corporation agrees to pay 20% on $1,000,000, the tax payment would be $200,000. Now the employee has a tax liability of $200,000 and the tax payment on that would be $40,000, which would also constitute income to the employee. *See, e.g.*, Old Colony Trust Co. v. Comm'r, 87 F.2d 131 (1936).

242 *See CEO Compensation Hearings*, *supra* note 138, at 28 (prepared statement of Sean Harrigan, President, Board of Administration, California Public Employees' Retirement System) (noting that there "appears to be an attitude of entitlement[s]," including gross-up provisions covering executives' tax liabilities, "in the executive suite of corporate America."); STAFF OF J. COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 200 (Joint Comm. Print 1984).

243 *See* Julie Cresswell, *Pay Packages Allow Executives to Jump Ship with Less Risk*, N.Y. TIMES, Dec. 29, 2006, at A1.

In summary, because parachute payments are often still part of executive compensation contracts, whatever the reasons, corporations are now losing deductions for any excess compensation paid plus the extra twenty percent excise taxes often paid on behalf the executives. As such, the anti-golden parachute provisions do not make the corporate compensation structure better for shareholders; rather, they make the whole prospect more expensive for the shareholders. While the executives remain in the same favorable position, the corporations have to forfeit the deductions, resulting in less profit for the shareholders. In addition, the shareholders still face the possibility that the corporation is too expensive to purchase. These results are inconsistent with the intent behind the provisions, mainly to help protect shareholder interests.

III. RESULTS OF CONGRESSIONAL ACTION IN EXECUTIVE COMPENSATION AND SOLUTIONS

A. RESULTS OF CONGRESSIONAL ACTION IN EXECUTIVE COMPENSATION

In spite of, or maybe because of the provisions Congress has enacted to regulate executive compensation, executive compensation continues to grow.[244] In fact, as a result of the growth in the use of stock options and a concurrent boom in the stock market in the late 1990s, very high amounts of executive compensation have become the norm.[245] Even though § 162, the basic code provision that regulates whether executive compensation is deductible, requires that a compensation amount be ordinary and necessary, it is difficult to see how executive compensation will fail this requirement in many instances. The compensation of executives is an ordinary expense, and as a result of the growth of the stock market, the amount that is considered reasonable has increased dramatically.

This is really an ability-to-pay theory of tax equity. Presumably, the benefit of the deduction for compensation expenses to the corporation inures to the shareholders. Denying that benefit therefore hurts the shareholders but does not hurt executives because the executives' pay is not affected whether the corporation is able to deduct the compensation or not. Similarly, under § 162(m), a corporation can get the deduction if it issues performance-based stock options. It appears that the benefit of deduction comes at the expense of diluting shareholders' ownership interests. Therefore, §§ 280G and 162(m) look as if they are regressive in nature. It would seem more appropriate if the tax laws designed to limit compensation targeted the ultimate expense to executives, rather than

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244 Sahadi, *supra* note 10; *see also* sources cited *supra* note 7.
245 Sahadi, *supra* note 10; *see also* sources cited *supra* note 7.

shareholders.[246] The same can be said of stock options. The corporation can get the deduction if the corporation complies with § 162(m) by issuing performance-based stock options, but only if it dilutes shareholder ownership interests by issuing the options. Therefore, §§ 280G and 162(m) are regressive in nature. The tax law should target executives, not shareholders.[247]

Congressional legislation tying compensation to stock options was a mistake. The reality is that shareholders and corporate executives have different interests.[248] Shareholders own the corporation and want to see the corporation grow profitable, distribute proceeds, and minimize costs. Executive compensation is an expense of the corporation, and executives expect to be paid well. Trying to merge these interests by giving executives stock ownership in the hope that they would adopt the goals or motives of shareholders does not appear to work. It may also be unnecessary. For example, there are job preservation incentives—the idea that executives will perform well because they want to keep their jobs.[249] Therefore, with better corporate governance, executives might have to

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246 This might be achieved through a more progressive tax system. *See* Brian R. Cheffins, *The Metamorphosis of "Germany Inc.": The Case of Executive Pay*, 49 AM. J. COMP. L. 497, 511–12 (2001) ("If a country's tax regime is strongly 'progressive' in the sense that the marginal rate (the rate applicable to any further taxable income) increases substantially at higher levels of pay, this will tend to dampen increases in executive pay. Under such circumstances, top managers will not value additional income as much as they would in a more liberal tax regime because they will keep less of what they earn.").

Over the last twenty years, the United States has had the lowest historical tax rates since 1917, excluding the period from 1925 to 1931 where tax rates were between 24 and 25%. *See* Top Marginal Income Tax Rates 1913–2003, http://www.truthandpolitics.org/top-rates.php (last visited Feb. 18, 2008). Tax rates in the 1930s ranged from 63% to 79%. *See id.* From 1940s to 1960s, tax rates ranged from 70% to 91%. *See id.* In the 1970s and early 80s, tax rates on earned income was 50–60%. *See id.* It was in 1987 that tax rates dropped to 38.5% and then to 28% in the following year. *See id.* Much higher tax rates are thus not unheard of and might result in a more fair result because they would require those earning more to take on a larger share of the tax burden.

Higher marginal rates could result in distortions of behaviors, just as §§ 162(m) and 280G distorted corporate behaviors. However, legislative solutions to these problems may be available. For example, recently there have been calls to repeal many provisions that are used to shelter income to avoid falling into higher tax brackets. *See* Martin J. McMahon, Jr., *The Mathew Effect and Federal Taxation*, 45 B.C. L. REV. 993, 1002–05, 1128 (2004). Moreover, the costs of any behavior distortions tolerated by Congress will accrue to the government, not to shareholders. Finally, higher marginal rates would not only affect executives, but would extend to other groups of tax payers as well. *See id.* This seems entirely consistent with the ideals Congress espoused when it enacted § 162(m). The corporate form is not the only type of business entity paying extreme amounts of compensation. *See* Beck, *supra* note 206, at 28; Mattingly & Rubin, *supra* note 205. The tax burden should be applied at the receiving end of the compensation, to the taxpayer being paid the amounts, not at the corporate or entity level at a greater cost to investors. Increasing the marginal rates assures that the appropriate party is paying the tax irrespective of the entity paying the compensation.

247 *See* sources cited *supra* note 246.

248 *See* Kahan, *supra* note 207, at 1877–78.

249 *See id.* at 1879–80.

perform their jobs well to be successful and to maintain their employment.

Because the tax code provisions have resulted in more compensation being paid in less conventional ways, such as stock options, shareholders have had an increasingly difficult time determining exactly how much executives are paid.[250] The difficulty stems from confusion in disclosures to shareholders detailing how compensation will be calculated when paid in the form of stock options, other compensation amounts being paid based upon performance criteria, and golden parachute payments with gross-up provisions. While the code provisions presumably sought to foster greater shareholder participation, they have in fact made participation more difficult.

If the code provisions are repealed, then perhaps the dynamic between executives and boards of directors with respect to stock options will shift. Eventually executives may wish to be paid in cash, which is more secure than stock options. Directors will no longer be motivated to offer significantly more value in stock options than cash to the executive, because either way the compensation will be deductible. As a result, corporations will return to cash as the primary form of executive compensation. With a return to cash compensation, shareholders will likely be able to determine what executives are actually being paid and whether they in fact deserve that amount based on the performance of the corporation. Furthermore, this will allow corporate compensation to be closer to on par with the compensation paid to executives in other types of entities—such as partnerships—which are not subject to these code provisions.

Congress has failed to rein in executive compensation through the tax code and the failure resulted in executives receiving even larger amounts of compensation. Because of the push to performance-based compensation, corporate behaviors have also become distorted, and many executives receive stock options as a major part of their compensation package. Coupled with the stock market boom in the later part of the 1990s, executive compensation grew to unprecedented levels. Moreover, the disclosure to shareholders of these stock option plans has been insufficient and opaque. Shareholders have difficulty in determining exactly how much executives were going to get paid. The cost to shareholders grew as a result of the enactment of §§ 162(m), 280G, and 4999. Executives received either the same amounts as they received before or in most cases greater amounts, and corporations either converted the compensation to stock options or forwent the deductions. In the case of §§ 280G and 4999, corporations can no longer take deductions for any

[250] *See supra* pp. 400–04.

excessive parachute payments and also now pay the penalty taxes on behalf of the executives. Ultimately, shareholders bear the cost.

In addition, because executive pay is now often based on stock prices through the use of options, executives are motivated to engage in activities that serve to increase the stock price of a corporation even if the effects are merely short-term—allowing the executives to maximize the value of their stock options. However, the results of the executives' actions over the long term are often not in the best interests of the corporation. Therefore, linking executive compensation to stock options cannot effectuate § 162(m)'s goal of aligning the interests of shareholders and executives because the motives of the two are fundamentally different. Furthermore, linking executive compensation to stock prices has result in illegal, fraudulent, or unethical behaviors on the part of executives to inflate the prices of the stock of the corporations they worked for, ultimately at a much greater cost to shareholders.

Corporations continue to pay executives the amounts of compensation that they used to pay because that is what the market demands. Corporations, acting in the best interests of their shareholders, seek to hire the most talented executives they can find. This requires corporations to pay the market rate for these executives. As a result of the tax provisions enacted by Congress, the current market rate for executive pay has increased dramatically. Corporations will continue to pay executives salaries comparable to what they might be paid at other corporations.

Congress was shortsighted when it enacted § 162(m). The provision does not take inflation into account with regard to the $1 million cap. In addition, by setting a fixed maximum amount of compensation, Congress overruled the premise that had governed the reasonable compensation jurisprudence under § 162—that the amount of compensation itself does not necessarily cause compensation to be considered unreasonable.[251] Congress fixed the reasonable compensation for publicly-held corporations (not for other types of entities such as partnerships) at $1 million. Congress also ignored many of the other traditional factors deemed critical to the determination of reasonableness, including the comparable amounts paid to similarly situated executives, the size of the corporation, and the responsibilities of the executive.

Congress stated that § 162(m) was not intended to supersede § 162 but to add another component to it.[252] The question of whether compensation was reasonable still must be answered under § 162, and in no event can compensation paid by a corporation to certain executives be

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[251] William S. Gray & Co. v. United States, 35 F.2d 968, 974 (Ct. Cl. 1929); *see supra* pp. 396–97.

[252] *See* SEN. COMM. R., *Revenue Reconciliation Act of 1993*, § 13211, n.1.

reasonable if it exceeds $1 million and is not performance-based.[253] However, by disregarding the factors that distinguish various corporations and imposing a flat rate of acceptable compensation, Congress has essentially superseded § 162 to the extent that § 162 seeks to regulate excessive executive compensation.

Congress did try to allow businesses to pay other, more variable compensation. A business may take into account many of the factors under § 162, provided the payment of the compensation is performance-based.[254] However, Congress greatly diminished the utility of the provision by making a blanket assumption that stock options were performance-based, it essentially thwarted the utility of the provision. It is true that stock values can go up as a result of the good performance of an executive, but stock values can also go up as a result of many other factors. None of the other variables that affect stock values are taken into account in the performance-based exception to § 162(m). On the other hand, an executive can actually perform very well, yet the stock price can still drop. Again, this is not contemplated in the performance-based exemption for stock options.

In addition, by selectively applying the limitations to corporations, Congress is limiting executive compensation in one type of business while allowing the freedom to set compensation in all other types of businesses. For example, partnerships are free to set compensation amounts of their executives at the level that they determine appropriate without restrictions on deductions.[255]

The intent of the legislation is further defeated by the new forms of compensation it incentivizes corporations to give to their executives. Corporate behavior is not being shaped to reduce the amount of compensation paid or link performance when new types of payments are examined. Many executives now receive massive severance amounts, for example. Presumably if an executive were being terminated, that executive had not performed well. If the effect of the legislation were to tie performance with compensation, there would be no need for these large severance packages. Yet as mentioned above, these severance amounts continue to be paid. While the severance packages would not be subject to §§ 280G and 4999, they would still be subject to §§ 162 and

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253 I.R.C. §§ 162, 162(m) (West 2007).

254 *Id.*

255 *See* Susan J. Stabile, *Viewing Corporate Executive Compensation Through a Partnership Lens: A Tool to Focus Reform,* 35 WAKE FOREST L. REV. 153, 228 (2000). In her article, Stabile argues that partnership executive compensation payment practices may also be applied to the corporate setting and offered the partnership agreement mode as an "alternative lens" through which to evaluate executive compensation in public corporations. *Id.*

162(m).[256] Severance payments are intended to compensate executives for the risk of switching jobs, and thus their only connection to performance might be the executives' performance at their previous employers. The shareholders have not had the benefit of their good performance, and yet they are paying the executives for the performance. While these payments will also be subject to §§162(m) and 162, they also continue to be paid. Even if the payments are ultimately determined not to be performance-based under the code, the corporations are still making the payments, and the ultimate cost is borne by the shareholders because of the lost deductions.

The effects of the tax legislation Congress enacted to rein in excessive executive compensation are not only unintended and contrary to the legislative purpose but also ineffective.[257] The legislative intent behind these provisions was to respond to criticism that executive compensation amounts were too high and to protect the returns of shareholders. Neither of these goals has been achieved by the provisions. In fact, both of these goals have been completely thwarted by the actual effects of the provisions.

B. SOLUTIONS

Some proposals have suggested limiting executive compensation to some figure based upon the amount that an average worker makes.[258] This is not really any different from the $1 million cap. The amounts might be different for different corporations, but this could still be subject to the same types of manipulation used to get around the current provisions. Corporations could use strategies to inflate the amounts that average workers are paid or find ways to give equity compensation or ownership to executives. Corporations could also choose to ignore any imposed limitations and incur more costs, which would only harm the shareholders. In addition, because executives make so much more than an average worker, the limitations would be ineffective unless a massive pay cut for executives were envisioned.

One has to acknowledge that the nature of the executives' job and that of many rank and file workers are different. The skill sets and talents involved are different as well. Perhaps there is a justification for paying executives the high amounts that they receive. It is in the best interests of a corporation and the shareholders to hire the best executive

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256 It should be noted that severance payments in the form of stock-options would still be considered performance-based under §§ 162 and 162(m).

257 *See Corporate Law Symposium*, *supra* note 127, at 794.

258 *See* Income Equity Act of 1999, H.R. 740, 106th Cong. § 2(a)(i)(2) (1999) (proposing a limitation on a corporation's deduction of executive compensation up to twenty-five times the amount paid to the lowest paid employee in the corporation); Income Disparities Act of 1991, H.R. 3056, 102d Cong. § 2(a)(i)(2) (1991).

they are able to find for the job. If the justification for paying executives more is legitimate, then the code provisions enacted are counter-productive by trying to limit what executives are paid.

Over fifty percent of the American public owns stock, either directly, through 401(k)-type plans, or other investments.[259] Aiming to get the best results for these shareholders will help distribute income and wealth more evenly. Because the shareholders are the owners of the corporations, allowing the shareholders the best possible returns will allow more corporate profits to be distributed. This may include paying the market rate for executive talent. The ultimate result of the tax provisions geared towards controlling excessive executive compensation has actually placed shareholders in a worse position than before the provisions were enacted. On the other hand, the government is profiting because of the additional tax they collect as a result of lost deductions and excise taxes. Section 162(m) was not intended as a revenue-raising provision, but at its very best that is all it has accomplished.[260] The shareholders ultimately bear the costs of these provisions—not the executives or the corporations who choose to pay the compensation.

Currently-enacted legislation does not adequately address excessive compensation. Rather, the provisions backfired and resulted in greater amounts of compensation and greater costs to shareholders and corporations. Ultimately, corporations determined it was in their best interests to pay executives more in order to ensure better talent, even if the compensation resulted in greater costs to the corporation and shareholders. To be competitive and successful, businesses would hire the most talented executives available for the position. Too many variables and factors exist to address compensation with one fixed amount. The attempt to favor stock options was misguided and resulted in more costs to the shareholders as well as rampant fraud through misstated earnings and backdating of stock options.

If § 162(m) were repealed, it might result in a return to cash compensation as opposed to stock options. Executives may be willing to be paid less if they are given the security of cash compensation rather than stock options. This presupposes that executives actually believe that stock options are risky. Further, if compensation packages had a larger cash component, shareholders would be able to have a clearer understanding of what the executives are being paid. If the shareholder approval requirement of § 162(m) was retained, shareholders might be more likely to act on executive compensation once the amount of the packages was clearer. In addition, cash compensation better reflects the different motives of shareholders and executives. While it was idealistic

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[259] *See* Hagenbaugh, *supra* note 43, at 1A.
[260] *See generally* Reilly, *supra* note 197.

and ambitious to try to align shareholder and executive interests, the reality is that their interests in the corporation differ. Executives do not work for a corporation for long-term financial growth. Although many would probably enjoy such growth, it is more likely that executives aim for shorter-term increases in value to cash out as quickly as possible.[261] The difference in these motives must be acknowledged and not ignored.

Repealing § 162(m) would also remove the incentive for executives to increase stock prices against the interests of the corporation. The recent wave of corporate scandals have made it apparent that many corporate executives will seek to increase or inflate stock prices even if it means engaging in fraudulent or illegal activities. At least part of the motive to inflate stock prices is that compensation, as a result of § 162(m), is tied to stock prices. If executive compensation is tied instead to the performance of the executive through evaluation by the shareholders and the board of directors, executives may act more willingly in the best long-term interests of the corporation.

Section 162 could be used more effectively to address excessive executive compensation. Although it has not been typically used to address excessive amounts of executive compensation, the tools are available. A uniform test could maximize the effectiveness of § 162 when courts determine whether executive compensation was excessive. An additional provision in the regulations or the code providing for a uniform test would provide this guidance to the courts. For example, a comparison of similarly-situated employees in businesses of the same size and nature, the employee's expertise, time devoted, and importance to the business would all be critical factors to the determination. A finding as to the employee's contributions to the business would also be critical. Finally, the independent-investor test is vital to determining if compensation is excessive or unreasonable. The ultimate goal of Congress was to maximize the value to shareholders and protect shareholder returns. The independent investor test would be the most consistent way to accomplish these goals. Section 162 has the potential to successfully regulate excessive executive compensation if it provides sufficient guidance to tax payers and courts as to its application.

Furthermore, if shareholders ultimately determine that the corporate assets are being misused, courts must be responsible for addressing these concerns. While many state legislatures have created statutes that allow shareholders to seek recourse if a board of directors is not sufficiently regulating executive compensation,[262] courts have not always responded

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261 *See* REPORT OF INVESTIGATION OF ENRON CORPORATION, *supra* note 153, at 34 (Comm. Print 2003).

262 *See, e.g.*, DEL. CODE ANN. TIT. 8, §§ 124, 327 (2008).

favorably to such cases.[263] Courts must allow shareholders to monitor executive compensation whether such cases are brought on the basis of a breach of fiduciary duty, a breach of the duty of good faith, or the waste doctrine. While a discussion of these cases and state statutes is beyond the scope of this paper, the solution to protecting shareholders appears to lie in allowing shareholders to protect themselves. This is also consistent with allowing the market to determine executive compensation. If the system is not working as it should, shareholders should be able to have redress against those directors who are not doing their jobs.

Many cases have been brought against directors by shareholders for paying executives excessive compensation amounts, and most of these cases have failed. Courts hesitate to regulate the market, set a limit for executive compensation, or interfere in corporate affairs.[264] Although courts have not acted on limiting excessive compensation amounts, shareholder suits are an appropriate vehicle to address the issue.

CONCLUSION

Congress has determined that excessive executive compensation was unacceptable and must be remedied. Congress has attempted to regulate excessive compensation amounts through three provisions in the tax code: §§ 162, 162(m), and 280G. These provisions limit the amount of compensation for which a corporation may be allowed to take a deduction and impose penalty taxes on executives receiving excessive compensation. These sections have been ineffective because they caused executive salaries to increase at a greater cost to shareholders. This is in direct conflict with the legislative intent behind these provisions, which was to protect shareholders and rein in excessive compensation packages.

Shareholder returns were not ultimately protected by these provisions because the provisions have often been disregarded by corporations, resulting in a higher cost to shareholders because of the lost deductions. Alternatively, corporations have complied with the provisions in order to take a deduction for compensation paid in the form of stock options. This has resulted in a rise in compensation amounts. In the case of § 280G, corporations have continued to provide golden parachute payments to executives at greater cost to shareholders because corporations often pay the excise taxes on behalf of the executives. At the same time, § 280G addresses only golden parachute payments and

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263 *See, e.g.*, *In re* Walt Disney Co., 906 A.2d 27 (Del. 2006) (holding that the board of directors did not breach their fiduciary duty and the payment to Ovitz did not constitute waste of corporate assets despite the fact that Ovitz received $130 million in severance payment for fourteen months of service on a five year contract).

264 18B AM. JUR. 2D *Corporations* § 1660 (2007).

not other pay packages that have emerged since its enactment. Presumably, Congress thought that many of these outlandish severance payments, if not justifiable, would be addressed by courts through shareholder suits; however, this has not been the result. Instead, courts have been hesitant to intervene on compensation matters.[265]

Section 162(m) also failed to fulfill its legislative purpose. Section 162(m) sought to reduce excessive compensation by capping the amount of compensation for which a deduction may be made at $1 million. The thought was that corporations would limit executive compensation to ensure the ability to take the deduction or link compensation to performance to take advantage of the deduction. In theory this aligned the interests of shareholders and executives by giving executives a vested interest in increasing shareholder returns. However, corporations often choose to forgo the deduction and compensate executives in excess of $1 million in order to retain the best talent. The inability to take a deduction means additional costs for shareholders.

Connecting executive compensation to performance of the executive and the corporation did not result in aligning the interests of shareholders and executives. Because the Treasury regulations specifically stated that stock options were an acceptable method to link executive compensation and performance, many corporations attempted to comply with § 162(m) by converting compensation from cash to stock options. The reality is that stock options are not an appropriate way to align those interests. While both shareholders and executives would like to see the corporation become more profitable, executives prefer short-term growth, which allows them to cash in their profits sooner, while shareholders prefer long-term growth. This misalignment resulted in both the ineffectiveness of § 162(m) and a direct conflict with the intent of Congress.

Rather than aligning the interests of executives and shareholders, the grant of stock options often resulted in executives engaging in risky behaviors to increase the price of the stock to maximize their compensation. It further encouraged some executives to engage in fraudulent or illegal activities to garner even greater compensation. In the wake of recent scandals, this is clearly not in the best interests of the shareholders who ultimately have to pay for the behavior of the executives. For example, the corporation's stock may decrease in value in the long run because of the executives' risky behavior. This loss would be born by the shareholders while executives can still collect their compensation by cashing in their stock options quickly regardless of the long-term loss to the corporation.

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265 *See, e.g.*, *In re* Walt Disney Co., 906 A.2d at 745–49 (2005).

Although well intentioned, §§ 280G and 162(m) appear to have been misguided when consequences of the provisions are examined in hindsight. The provisions failed to reduce costs to shareholders or align the interests of shareholders and executives. Instead, the provisions resulted in greater costs to shareholders and behaviors of executives that put shareholder returns at greater risk. Therefore, these provisions should be repealed.