Executive Compensation and Corporate Governance

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Penalty taxes for executive compensation have long attracted support from both liberal and conservative policymakers. In 1984, a Democratic House, a Republican Senate, and a Republican president denied tax deductions to companies making golden-parachute payments and imposed a 20-percent surtax on executives receiving such payments. In 1993, a Democratic Congress and a Democratic president set a $1 million cap on the tax deduction for most forms of compensation paid to a corporation's top five executives. In 2004, a Republican Congress and a Republican president enacted penalties, including a 20-percent surtax, for certain deferred-compensation arrangements. And in 2017, a Republican Congress and a Republican president repealed the main exceptions to the $1 million deduction cap. It seems that few policymakers on either side want to appear soft on executive compensation.

Underlying these penalty taxes are two assumptions widely shared by legislators, the popular press, much of the public, and many academics. First, it is generally assumed that contemporary executive compensation generally represents a failure of corporate governance. In certain quarters, it is very nearly an article of faith that executive pay is too high, both in absolute and relative terms. Such exorbitant compensation, the assumption runs, cannot possibly be the result of arm's-length bargaining between executives and corporate directors. Rather, it reflects the outsized influence – or even control – that executives exercise over directors. CEOs in particular are said to receive pay far in excess of the value of their services, to the general disadvantage of shareholders and rank-and-file workers.

Second, it is generally assumed that tax policy can correct this corporate-governance failure. Since the enactment of the golden-parachute penalty taxes in 1984, Congress has turned to the tax law (along with securities law) as a preferred approach in its efforts to reshape executive compensation. The basic mechanisms for doing so have not been particularly

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imaginative. Sometimes, as with deferred compensation, Congress imposes a penalty tax on the executive; sometimes, as with the $1 million cap, Congress denies a corporate tax deduction; and sometimes, as with golden parachutes, Congress does both. The underlying expectation (perhaps it is more of a hope) is that directors and executives will structure executive-pay arrangements to avoid those penalties, thereby reaching the outcomes policymakers want.

The first assumption has long been contested. Generally known as the "managerial-power" theory of executive compensation, it has some empirical support (Hlaing and Stapleton, 2022). But there is also empirical support for the "optimal-contracting" theory of executive compensation, which maintains that directors bargain with executives at arm's length to reach compensation arrangements promoting shareholder interests (Edmans *et al.*, 2017; Edmans and Gabaix; 2016; Kaplan, 2012). It is difficult, at this point, to favor either theory as the clearly superior account (Walker, 2012b). It may well be that the managerial-power theory better explains executive pay in certain cases and that the optimal-contracting theory better explains executive pay in other cases (Edmans *et al.*, 2017; Walker, 2012a). And it may also be that still other explanations are needed to explain particular compensation arrangements (*e.g.*, Frydman, 2019; Frydman and Papanikoulaou, 2018; Murphy, 2013).

But after nearly 40 years of using tax law to regulate executive pay, the second assumption should be rejected as almost certainly wrong. Most of the tax rules for executive compensation have had only weak effects, and unintended consequences have often dominated the intended ones. The $1 million cap is particularly instructive. As originally enacted in 1993, Internal Revenue Code section 162(m) denied a deduction for executive pay in excess of $1 million, but it expressly exempted performance-based compensation and it implicitly exempted most deferred compensation. Section 162(m) may have had modest effects on the base salaries paid to executives, but overall executive pay rose substantially during the second half of the 1990s, perhaps in part because the exception for performance-based compensation may have encouraged companies to increase stock-option grants (Walker, 2012b).

And there is a more serious concern with the use of tax policy in this area. The adverse tax consequences imposed on golden-parachute payments, deferred-compensation arrangements, and compensation of more than $1 million generally fall on the corporation. The point is readily apparent in the case of denied deductions. Compensation paid to an executive that is otherwise deductible as an ordinary and necessary business expense becomes non-deductible if it is an excess golden-parachute payment or if it exceeds the $1 million limitation. But even the penalty taxes imposed on an executive for a failed deferred-compensation arrangement or for an excess parachute payment are readily shifted to the corporation through an indemnification agreement, often with a requirement that the corporation make a gross-up payment for the additional income and penalty taxes incurred by the executive when the corporation pays on the executive's behalf.

In both cases, the ultimate effect is to increase the tax paid by the corporation. That, in turn, increases the economic burden that the corporate income tax imposes on shareholders and rank-and-file workers. But according to the managerial-power theory, shareholders and rank-and-file workers are the very people harmed by excessive executive compensation in the first place. The outcome is really remarkable. On the assumption that directors and executives conspire against shareholders and non-executive employees – using corporate assets to pay rents to executives rather than to improve the returns to shareholders or to increase the pay of rank-and-file workers – Congress responds by further penalizing those shareholders and rank-and-file workers.

I. Executive Compensation as a Corporate-Governance Failure

It seems clear that legislators generally assume that corporate directors do not act strictly in the interests of shareholders when they bargain over executive compensation. This corporate-governance failure is thought to manifest itself in both the levels and the components of executive pay. The assumption is that, through the cooperation of pliable directors, executives in many cases effectively set their own compensation.

A. Excessive Pay Levels

Polls regularly find popular dissatisfaction with executive compensation (Burak, 2018), and it is routine in certain policy circles to describe executive pay in unflattering terms such as "bloated," "outrageous," and even "obscene" (AFL-CIO *et al*., 2021; Baker *et al*., 2019). Concerns about executive compensation implicate both the narrow interests of corporate shareholders and broad questions of social welfare. Thomas Piketty, for example, argues that executive compensation is a significant determinant of income inequality (Piketty, 2014; see also Brou *et al.*, 2021).

Criticisms about the level of executive compensation have two aspects. First, executive pay is said to be too high in absolute terms. In 2020, the average total compensation among CEOs at the 350 largest public companies was $24.2 million (Mishel and Kandra, 2021).[2] This reflects impressive growth over the past few decades. After remaining fairly constant from the 1940s to the middle of the 1970s (Frydman and Saks, 2010), the average annual CEO compensation at the 350 largest public companies increased 1,322 percent, in real terms, between 1978 and 2020 (Mishel and Kandra, 2021). As always, pay for executives at the very top attracts considerable attention. In 2019, the CEO of Thermo Fisher Scientific, Inc. was paid more than $85 million, the CEO of HCA Healthcare, Inc. was paid more than $109 million, and the CEO of Oracle Corporation was paid more than $162 million (CG Lytics, 2020). By comparison, the U.S. median household income in 2020 was just over $67,500 (Shrider *et al.*, 2021).

Second, executive pay is said to be too high relative to the pay of corporate rank-and-file employees. Critics have long pointed to increases in what is generally known as the "pay ratio" – the ratio determined by comparing the pay of a company's CEO to median (or sometimes mean) pay of the company's rank-and-file workers.[3] Different analysts calculate the pay ratio differently, but it is clear that the ratio has been increasing for decades. In 1965, the ratio was 21 to 1; in 1978, it was 31 to 1; in 1995, it was 118 to 1; in 2000 (at the height of the technology

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[2] This figure includes the amounts includible in an executive's gross income when shares of restricted stock become vested and when stock options are exercised. A different measure of compensation, which looks to the value of restricted stock and stock options when granted, yields an average total-compensation amount for 2020 of $13.9 million (Mishel and Kandra, 2021).

[3] Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 requires a public company to disclose the ratio of the median compensation of the company's employees (other than the CEO) to the total compensation of the company's CEO.

bubble), it was 368 to 1; and in 2020, it was 351 to 1 (Mishel and Kandra, 2021).[4] The objection is obvious: CEO compensation has increased significantly more over the past half century than has the compensation of non-executive employees.

B. Inappropriate Types of Pay

At times, it is not just the level of executive pay that policymakers and others find objectionable; rather, it is the specific type of pay. During the increased merger activity of the early 1980s (Ravenscraft, 1987), critics took aim at golden parachutes – severance payments made to executives of a target company following a takeover (Murphy, 2012). Legislators determined that golden parachutes hinder certain acquisitions that advance shareholder interests, encourage certain acquisitions that harm shareholder interests, and divert amounts paid by purchasers from shareholders to executives (Joint Tax Committee, 1984).

Next by the late 1980s and early 1990s, there were concerns that executive compensation was not closely linked to corporate or individual performance (Crystal, 1991; Jensen and Murphy, 1990a; Jensen and Murphy, 1990b). It was thought that in too many cases, executive pay was effectively guaranteed, either as base salary or as fixed bonuses. But just a few years later, performance-based compensation itself became the target of criticism, with stock options emerging as the new *bête noire*. By 2000, stock options, on average, accounted for more than half of CEO pay at the largest companies (Murphy, 2013). As critics pointed out, the compensation payable on the exercise of a stock option increases with a rising market, even if a particular company's performance lags behind that of its competitors (Walker, 2012b).

The accounting scandals and corporate failures of the early 2000s – particularly those involving Enron, WorldCom, Tyco, and Global Crossing – put additional pressure on the use of stock options in executive-pay arrangements. Critics argued that stock options give executives a powerful motivation to boost the value of their companies' stock, including through excessive risk-taking and misrepresenting financial results (Brou *et al*., 2021; Hlaing and Stapleton, 2022; Murphy, 2013; Tingle, 2017). Revelations that many companies had backdated stock-option

[4] These figures use mean compensation for rank-and-file workers.

grants so that options granted in-the-money appeared to have been granted at-the-money only underscored the objections (Lie, 2005).

Finally, the collapse of Enron in the fall of 2001 put nonqualified deferred compensation on the hot seat. Measured against common practice, Enron's deferred compensation plans were only moderately aggressive, but they included "haircut" provisions allowing executives to request immediate distribution of 90 percent of their deferrals with a voluntary forfeiture of the remaining 10 percent. Several Enron executives used the haircut provisions to withdraw more than $50 million of deferred compensation from the plans as Enron slid toward bankruptcy (Doran, 2004; Joint Tax Committee, 2003) Deferred compensation, which previously was considered a relatively benign component of executive pay, was now seen as a way for executives to divert assets from a company's external creditors prior to bankruptcy.

C. The Theory of Executive Power and Executive Pay

The assumption that executive compensation represents a failure of corporate governance derives from a theory with widespread support in the academy. This is the managerial-power theory, perhaps most closely identified with Lucian Bebchuk and Jesse Fried of Harvard Law School. The theory builds on longstanding insights about the separation of ownership and control in public companies (Berle and Means, 1932) and about the agency costs associated with that separation (Jensen and Meckling, 1976). According to the managerial-power theory, executives have undue influence and or even outright control over the directors who determine the executives' compensation (Bebchuk and Fried, 2004; Chapas and Chassagnon, 2021). Rather than bargain with executives at arm's length and strictly in the interests of shareholders, directors defer to the demands of executives and approve compensation arrangements that cut against shareholder interests. Managers, in effect, capture pliable boards of directors and extract rents from corporate revenues (Bebchuk and Fried, 2004; Piketty, 2014).

The managerial-power theory offers an explanation not just for the levels but also for the components of executive compensation. Executives, the theory holds, prefer pay that is not contingent on their own performance or the performance of the companies they lead, and they demand protection against the involuntary loss of their sinecures, such as might occur following a change in corporate ownership or control (Bebchuk and Fried, 2004). For these reasons, executives want to be paid salaries and fixed bonuses; they want golden-parachute arrangements and generous severance packages; and they want expansive deferred-compensation arrangements and other forms of "stealth compensation" to help conceal ("camouflage") the true value of their pay arrangements, thereby minimizing the "outrage costs" otherwise imposed by shareholders and the public (Bebchuk and Fried, 2004).

But the managerial-power theory is contested (*e.g.*, Cremers *et al.*, 2017; Frydman and Saks, 2010; Kaplan, 2012), and there are other theoretical explanations of executive compensation. Most prominently, the optimal-contracting (or shareholder-value) theory holds that executive compensation is a solution to – rather than a symptom of – the agency problem in the management of public companies (Edmans *et al*., 2017; Jensen and Murphy, 1990b). First, the levels of executive pay reflect the importance of highly talented executives to corporate success. Demand for outstanding executives exceeds supply, and companies must pay a premium to attract and to retain such executives. Second, the components of executive-compensation arrangements align the interests of executives with those of corporate stakeholders. Salaries and guaranteed bonuses discourage executives from undertaking risk, so other types of compensation are needed to provide countervailing incentives. Stock options, restricted stock, and other forms of equity-based compensation align managerial interests with the interests of shareholders, and nonqualified deferred compensation aligns managerial interests with those of unsecured lenders (Jensen and Meckling, 1976).[5]

Increasingly (if somewhat belatedly), scholars are also analyzing the legal and institutional factors that at least partially determine executive compensation (see, *e.g.*, Doran,

[5] There are still other theoretical explanations of executive compensation. For example, the tournament theory holds that a principal function of executive compensation is to provide performance incentives for a company's junior employees and for executive candidates in the labor market (Lazear and Rosen, 1981). The underlying notion is that employees and outside candidates compete for promotions and for the greater pay associated with higher positions. Outsized pay for the CEO represents the prize for the tournament winner (Islam *et al.*, 2022; Lazear and Rosen, 1981).

2017a; Edmans *et al*., 2017; Hlaing and Stapleton, 2013; Murphy, 2013; Murphy, 2012; Murphy and Jensen, 2018). These generally cut across both the managerial-power theory and the optimal-contracting theory. For simplicity, consider just the tax rules for executive compensation. Certain tax rules (including some that reflect previous policy interventions) induce distortions in executive-pay arrangements. Whether corporate directors intend for executive-pay arrangements to facilitate executive rent extraction or to optimize executive incentives for the benefit of shareholders, those directors must take such tax distortions into account. Thus, for example, deferred compensation is a preferred type of executive compensation because of the reduced effective tax rate on investment income during the deferral period (Doran, 2017a). Similarly, stock options were long favored at least in part because they automatically avoided the $1 million cap on deductions for executive pay (Doran, 2017b). And the surtax on golden parachutes led to a common practice of corporations providing executives with indemnifications and "gross-up" payments (Murphy, 2013).

At a minimum, then, the first assumption underlying penalty taxes for executive compensation – specifically, the assumption that executive compensation represents a failure of corporate governance – is problematic. The managerial-power theory, although attractive to the general public and the popular press and accepted in certain segments of the academy, has not cleared the field of competing accounts. The longstanding optimal-contracting account also has considerable empirical support, and it may be that the two theories together more fully explain contemporary executive-compensation practices than does either theory alone. Additionally, legal and other institutional considerations undoubtedly affect various aspects of executive-pay arrangements without regard to the validity of either the managerial-power or the optimal-contracting theory. In particular, past attempts to reform executive compensation through penalty taxes have altered pay practices in ways not foreseen by policymakers.

II. Tax Policy as a Corrective Instrument

The second assumption grounding the use of penalty taxes here is that tax policy can correct the underlying corporate-governance failure that leads to excessive levels or inappropriate forms of executive compensation. The precise means by which penalty taxes supposedly correct the assumed corporate-governance failure are often left unstated, but legislators generally take it as given that directors and executives will respond to penalty taxes by changing the terms of executive-compensation arrangements. That appears to be true in some cases, but not in others; and even when true, it appears that the changes made by directors and executives are often not the changes that legislators wanted or anticipated. The penalty taxes on golden-parachute payments and deferred compensation are considered here; the penalty taxes on compensation over $1 million are considered in Part III.[6]

A. Golden Parachutes

In the Deficit Reduction Act of 1984, Congress enacted two penalties for what it called "excess parachute payments." The first penalty falls on the corporation that makes the excess parachute payment; the second falls on the executive who receives it. Specifically, Internal Revenue Code section 280G denies the corporation a tax deduction for the excess parachute payment, and Internal Revenue Code section 4999 imposes a 20-percent surtax on the executive who receives the payment. There was not even a pretense that golden parachutes offend traditional tax-policy concerns. Instead, Congress maintained that golden parachutes benefit executives at the expense of shareholders and characterized the penalty taxes as correctives to a corporate-governance failure (Joint Tax Committee, 1985).[7]

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[6] For the sake of brevity, temporary penalty taxes enacted under the Emergency Economic Stabilization Act of 2008 are ignored.

[7] Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 requires a public company that seeks shareholder approval of an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all the company's assets to seek shareholder approval of any golden-parachute payments.

The golden-parachute penalties apply only to what Congress considers an "excess parachute payment," which is defined as the difference between an executive's "parachute payment" and the executive's "base amount." A parachute payment is a payment to the executive that satisfies two conditions. First, the payment must be contingent on a change in the ownership or control of the executive's employer or a change in the ownership of a substantial portion of the employer's assets. Second, the payment must be at least three times the executive's base amount, which is the executive's average annual taxable compensation during the five years preceding the change in ownership or control. Reasonable compensation for services, including services performed after the change in ownership or control, is not a parachute payment.

To illustrate, assume that all the outstanding stock of Target Corporation is purchased by Acquiring Corporation. During the five years preceding the purchase, Chief Executive Officer of Target Corporation has an average annual taxable compensation of $10 million. Under Chief Executive Officer's employment contract with Target, the purchase of Target Corporation's stock triggers a payment of $30 million to Chief Executive Officer. Because the $30 million payment is contingent on a change in the ownership of Target Corporation and because it is at least three times the Chief Executive Officer's base amount of $10 million, the entire $30 million is a parachute payment. The excess parachute payment is $20 million, which is the difference between the $30 million parachute payment and the $10 million base amount. Under section 280G, Target Corporation may not deduct the $20 million excess parachute payment; and under section 4999, Chief Executive Officer must pay a $4 million surtax, which is 20 percent of $20 million.

Corporations and executives responded to the golden-parachute penalties in several ways that are not consistent with the corporate-governance outcomes that Congress intended. First, many companies that had not previously maintained golden-parachute agreements with their executives adopted such agreements after the penalties were enacted (Murphy, 2013). Second, in an effort to avoid the penalties entirely, many companies and executives agreed to characterize golden parachutes as compensation for consulting or other services to be provided by the executives after a change of ownership or control. Some of those agreements are more aggressive than others – for example, providing very large payments in exchange for nominal services.

Third, in some cases companies and executives agree that the company will forgo the tax deduction and will indemnify the executive for the 20-percent surtax. Because the indemnification payment is itself considered a parachute payment, such an agreement typically covers all income taxes and additional surtaxes triggered by the indemnification payment. This is known as a "gross-up" approach, and it quickly becomes very expensive. Assuming that Chief Executive Officer from the example above has a marginal income tax rate of 40 percent, the original $30 million parachute payment becomes $75 million once it is grossed up (a $75 million payment, after all taxes have been paid, leaves the executive with $30 million). No part of the $75 million payment is deductible. The gross-up approach obviously exacerbates the corporate-governance failure that Congress meant to correct. Yet, by 1999, most golden-parachute arrangements included gross-up provisions (Murphy, 2013).[8]

B. <u>Deferred Compensation</u>

In the American Jobs Creation Act of 2004, Congress enacted a 20-percent surtax on any executive whose nonqualified deferred compensation fails certain requirements. Internal Revenue Code section 409A provides that an executive with deferred compensation not meeting those requirements must include the deferred compensation in gross income as soon it vests, must pay an interest charge, and must pay a 20-percent surtax. Although tax considerations are an important determinant of deferred compensation (Doran, 2017a), the principal objective of section 409A, once again, was to correct a perceived corporate-governance failure – specifically, the undue control that corporations supposedly allowed executives to exercise over their deferred compensation in the event of an impending corporate bankruptcy or insolvency (Doran, 2004).

[8] Some agreements limit an executive's golden parachute to 299 percent of the executive's base amount, so that no portion of the golden parachute is an excess parachute payment. This approach generally satisfies the objective of limiting golden parachutes to what Congress considered an acceptable amount.

Before section 409A, deferred compensation was not heavily regulated by federal law. To achieve tax deferral for executives, a deferred-compensation plan had to avoid application of three partially overlapping tax doctrines: the economic-benefit doctrine (which Congress codified in 1969 at Internal Revenue Code section 83); the cash-equivalence doctrine; and the constructive-receipt doctrine. Avoiding current taxation under the economic-benefit doctrine and section 83 required that the corporation's deferred-compensation obligation be an unfunded and unsecured promise to pay and that the corporation not place assets for the payment of the deferred compensation beyond the reach of its creditors. Avoiding current taxation under the cash-equivalence doctrine required that the executive not be able to alienate his or her interest in the deferred compensation for value.

The application of the constructive-receipt doctrine to deferred-compensation plans had long been problematic before section 409A. The relevant tax regulation states that an individual is in constructive receipt of income that is "credited to [the individual's] account," "set apart" for the individual, or "otherwise made available so that [the individual] may draw upon it any time, or so that [the individual] could have drawn upon it during the taxable year if notice of intention to withdraw had been given."[9] But the regulation immediately qualifies that broad rule by stating that "income is not constructively received if the [individual's] control of its receipt is subject to substantial limitations or restrictions." The imprecision of the regulation led to decades of cat-and-mouse games between taxpayers and the government. During the 1980s and the 1990s, it became increasingly common for deferred-compensation plans to allow executives to make deferral elections as late as the eve of payment, to allow executives to make elections for the re-deferral of previously deferred amounts, and to allow executives to accelerate payment of their deferred compensation through a "haircut" distribution – that is, the early withdrawal of a specified portion, typically 90 percent, of the deferred compensation in exchange for a voluntary forfeiture of the remaining portion (Doran, 2004).

This last practice was of particular concern because haircut distributions potentially allow an executive to receive substantially all his or her deferred compensation as the

[9] Treas. Reg. § 1.451-2.

corporation approaches bankruptcy or insolvency. From the government's perspective, that is inconsistent both with the requirement that an executive not have control over the payment of his or her deferred compensation and with the requirement that deferred compensation remain subject to the claims of the corporation's creditors. Additionally, a supposed purpose of deferred compensation is to align the interests of executives with a corporation's third-party lenders (Erkan and Nguyen, 2021; Jensen and Meckling, 1976; Reid, 2018). A haircut distribution allows the executive, but not a third-party lender, to minimize the risk of non-payment, thereby undermining the alignment of interests. But corporations and executives took the position that the haircut constituted a substantial limitation or restriction and so was not inconsistent with tax deferral under the constructive-receipt doctrine (Doran, 2004).

Everything changed for deferred-compensation plans with the failure of the Enron Corporation in 2001. Enron executives had taken more than $50 million in haircut distributions during the weeks preceding the company's bankruptcy (Joint Committee on Taxation, 2003). Lawmakers saw this as a collusive arrangement between the company and its executives to ensure that the executives' deferred compensation would not really be exposed to the risk of Enron's insolvency. In response, Congress adopted section 409A, which tightens the constructive-receipt rules and sets out the terms and conditions under which compensation can be deferred, held, and distributed.

The constructive-receipt rules in section 409A fall into three groups. First, section 409A regulates distributions, providing that an executive's deferred compensation may be paid out only upon or pursuant to one of six distribution triggers.[10] Second, section 409A bans the acceleration of deferred-compensation payments. This provision was specifically intended to prohibit haircut distributions such as those taken by the Enron executives. Third, section 409A regulates elections, both as to initial deferrals and as to distributions. It requires that an executive's initial election to defer compensation be made before the start of the taxable year in

[10] These are: the executive's separation from service; the executive's becoming disabled; the executive's death; a date or schedule set out in the plan at the time of the initial deferral; a change in the ownership or effective control of the corporation; or the executive's unforeseeable financial emergency.

which the compensation is earned. It also imposes limits on an executive's elections to change the time or form of a distribution.[11]

When assessed against the underlying corporate-governance objective, the results under section 409A are mixed. Despite unnecessarily complex and turgid interpretive regulations (Doran, 2008), formal compliance with section 409A generally is not problematic. The statutory requirements are readily incorporated into the written terms of a nonqualified deferred-compensation arrangement, although indemnification agreements usually shift any adverse tax consequences of non-compliance from the executive to the corporation. So long as the administration of a deferred-compensation arrangement remains routine, few difficulties arise.

But the circumstances that gave rise to section 409A were not routine. As allegations of fraud at Enron became public and as the company's share price fell precipitously during the last few months of 2001, executives took extraordinary measures to withdraw their deferred compensation before the company filed for bankruptcy. Faced with similar circumstances today and the prospect of losing much or all of their deferred compensation in bankruptcy proceedings, executives of a failing company presumably would push the company's directors to agree to accelerated distributions in violation of section 409A. Although such distributions would trigger tax inclusion, an interest charge, and a 20-percent surtax, indemnification and a gross-up payment by the corporation would leave the executive no worse off.

It is not hard to see why this would be the likely outcome. After all, the assumption underlying section 409A is that directors and executives are disposed to enter into collusive arrangements that protect executives from losing their deferred compensation. Why would that disposition disappear exactly when such an arrangement is most important to the executives? Something is better than nothing, and with the corporation's bankruptcy on the horizon, the alternative to violating section 409A and receiving at least some deferred compensation may be receiving no deferred compensation. Section 409A thus achieves its core objective only if one

[11] Any such election may not take effect for at least twelve months; any election to change a distribution payable at a fixed time or under a fixed schedule must be made at least twelve months before the first payment is due; and any election to defer a distribution (other than one made by reason of death, disability, or unforeseeable financial emergency) must delay the distribution by a minimum of five years.

assumes away the corporate-governance failure that it is supposed to correct. As long as the corporate-governance failure persists, section 409A does as much to exacerbate the problem as it does to mitigate it.

III. The $1 Million Cap and the Anatomy of a Policy Failure

The most prominent penalty tax for executive compensation is the $1 million deduction cap that Congress enacted as part of the Omnibus Budget Reconciliation Act of 1993 and expanded substantially in the Tax Cuts and Jobs Act of 2017. There had been growing criticism in the late 1980s and the early 1990s that executive pay was both too large relative to that of rank-and-file works and too insensitive to individual and corporate performance. By 1993, the CEO pay at large public companies was more than 100 times average-worker pay; fifteen years earlier, it had been only 31 times average-worker pay (Mishel and Kandra, 2021). Additionally, it was said that corporate executives were "paid like bureaucrats" (Jensen and Murphy, 1990a; *cf.* Hall and Liebman, 1998) – that is, paid in large part just for being employed, regardless of how well or how poorly they performed and regardless of whether they enhanced or diminished organizational value. The perception of complacency and entitlement among U.S. corporate executives was thought to compare unfavorably with the strong work ethic and high level of accountability among their Japanese counterparts (Murphy, 2013; Rose and Wolfram, 2002). In response, Congress passed Internal Revenue Code section 162(m), which generally prohibits a public company from deducting more than $1 million in compensation paid to any of its top five executives.

Early legislative proposals for an executive-pay cap applied to all forms of executive compensation, but the version enacted in 1993 had two important exceptions, one implicit and the other express. The implicit exception was probably a drafting oversight. As written, the cap disallowed a deduction only for compensation paid while an executive was still employed by the company; it did not reach nonqualified deferred compensation paid out after the executive had retired or otherwise terminated employment (Doran, 2017b). Because the tax law imposes no limits on nonqualified deferred compensation, such payouts could run into the tens or even hundreds of millions of dollars, all of it deductible by the corporation (Doran, 2017a).

The express exception was for performance-based compensation. Specifically, section 162(m) did not apply to any compensation paid "solely on account of the attainment of one or more performance goals," as long as the performance goals were set by a compensation committee of outside directors, the material terms of the compensation were disclosed to and approved by the company's shareholders, and the compensation was not paid unless the compensation committee certified that those material terms had been met. Because section 162(m) set no deduction limit on performance-based compensation, legislators expected companies to respond by shifting performance-insensitive compensation to performance-based compensation. Officials in the Clinton Administration, which had proposed the $1 million cap, confirmed that the cap was intended to change executive-pay practices rather than to raise revenue (Reilly, 1994).

Although included in the tax code, section 162(m) was enacted as a corporate-governance measure. It was meant to change the nature of executive pay from the guaranteed, rubber-stamped compensation of bureaucrats to performance-sensitive pay approved both by shareholders and by outside directors. And yet, the exception for performance-based compensation proved to be a low hurdle. As interpreted by Treasury Department regulations, an acceptable performance goal could be based on the company's "stock price, market share, sales, earnings per share, return on equity, or costs," and the performance goal did not even have to require a "positive result."[12] The regulations said that an acceptable performance goal might require nothing more than "maintaining the status quo or limiting economic losses."[13] With so much flexibility, it was child's play for companies to design performance-based compensation that rewarded mediocrity or even outright failure.

Perhaps most importantly, the regulations gave a pass to stock options issued at or out of the money, as long as the company obtained advance shareholder approval of the plan under which the options were granted. The assumption was that an executive exercises an at-the-money or an out-of-the-money stock option only after the current stock price is greater than the

[12] Treas. Reg. § 1.162-27(e)(2)(i).

[13] Id.

strike price – that is, only if the stock price increases after the option is granted. That of course ignores the possibility that the stock price might increase with a generally rising stock market, as happened during the bubble in the technology sector between 1995 and 2000. Indeed, a generally rising stock market might pull up the stock of a particular company even as the company lags behind its competitors (Doran, 2017b). Also, it became clear during the middle of the 2000s that the tension between the need to grant at-the-money options and the desire to shield executives from risk encouraged many companies to backdate stock options, which had the effect of making options granted in-the-money options look as though they had been granted at-the-money (Lie, 2005).

Although it is impossible to know what would have happened to executive compensation if Congress had not enacted the $1 million cap in 1993, the cap does not seem to have led to a reduction in the level of executive pay (Murphy and Jensen, 2018). As of 2016, more than half of all companies in the S&P 500 paid base salaries of more than $1 million to their CEOs; in other words, those companies chose to give up tax deductions for at least some portion of CEO compensation (Doran 2017b). Additionally, the average of total CEO compensation at the 350 largest companies in 2020, including both performance-based and other pay, was $24.2 million; this is far more than the average of such compensation in 1993 (Mishel and Kandra, 2021). And the ratio of CEO pay to average-worker pay in 2020 had risen to 351 to 1 – again, far in excess of what it had been in 1993 (Mishel and Kandra, 2021).

Whether or not the $1 million cap affected the overall level of executive compensation, it likely did affect the types of executive compensation. Several scholars argue that the substantial increase in stock-option grants during the 1990s was a function of the relaxed treatment of stock options under the exception for performance-based compensation (*e.g.*, Murphy, 2012; Schizer, 2015), although there are other possible explanations for the increase in stock-option compensation (*e.g.*, Shue and Townsend, 2017). The cap may also have resulted in a greater use of performance-based compensation more broadly (*e.g.*, Balsam *et al.*, 2019; Perry and Zenner, 2001; *cf.* Rose and Wolfram, 2002). Measured against congressional intent in 1993, that might have been considered a policy success.

But Congress decided otherwise. In 2017, Congress declared that the shift in executive pay toward performance-based compensation had led companies and executives to give priority to short-term results over both long-term results and the interests of rank-and-file employees (Committee on Ways and Means, 2017). And so Congress radically revised the $1 million cap in the Tax Cuts and Jobs Act of 2017. First, Congress expanded both the class of corporations and the group of executives subject to the deduction cap. The cap now reaches corporations with publicly traded debt and all foreign corporations that are publicly traded in the U.S. through American depositary receipts, and it applies to the company's CEO, CFO, and three highest-paid executives other than the CEO and the CFO.[14] Second, Congress repealed both the implicit exception for deferred compensation and the explicit exception for performance-based compensation. Now, any executive who is covered by the $1 million cap in any year after 2016 remains covered by the cap forever, even for compensation paid after the executive has left the company. Additionally, all compensation is subject to the $1 million cap, whether or not it is dependent on performance.

As revised, section 162(m) is a pure penalty. Both in 1993 and 2017, legislators and others critical of executive compensation casually referred to the tax deduction for executive compensation as a "subsidy," but that is an analytic mistake. Compensation paid by a company to its employees, including the company's executives, is part of the company's cost of producing taxable income and, as such, is properly deductible under an income tax (Walker, 2011). The deduction is not a subsidy; it is necessary for the proper measurement of income. In certain cases, unreasonable or excessive compensation may be properly characterized as something else (disguised dividends, for example) and such compensation should not be deductible. But section 162(m) does not condition the deduction denial on unreasonableness or the excessiveness. It simply sets an arbitrary amount – an amount both well below average CEO compensation and not indexed for inflation – above which no deduction may be taken. The cap is punitive.

[14] Under a further expansion made by the American Rescue Plan of 2021, the cap will also apply to the next five highest paid executives (bringing the total to ten), starting in 2027.

This is not necessarily to say that section 162(m) represents bad policy. There are, perhaps, a few points that can be made in its favor. First, entirely apart from its effectiveness, the cap arguably has expressive value. Penalties define the limits of acceptable conduct (Doran, 2009), and by imposing a penalty on executive compensation in excess of $1 million, Congress in effect makes a statement that the payment of such compensation is not in the public interest. On the other hand, this statement, such as it is, lacks much meaning. In the three decades since the cap was enacted, most large companies have shown a strong inclination to ignore it. The failure to index the cap for inflation seems likely to reinforce that tendency. As more companies flout the $1 million cap, its expressive value will continue to erode.

Second, the 2017 changes to section 162(m) should have the salutary effect of removing whatever distortions to executive pay the prior version of the cap may have induced. Again, a number of scholars believe that section 162(m) changed the composition of executive compensation, especially by encouraging companies to issue stock options during the late 1990s; and again, the standard criticism of that practice was that, in a bull market, stock options reward executives without regard to corporate or individual performance. The elimination of the explicit statutory exception for performance-based compensation removes that distortion (Murphy and Jensen, 2018). That said, the exception for performance-based compensation had its roots in the widespread concern of the late 1980s and early 1990s that corporate pay was not dependent on performance (Crystal, 1991; Jensen and Murphy, 1990a; Jensen and Murphy, 1990b). It is possible, then, that the 2017 repeal of the exception for performance-based compensation will result in executives being paid more like bureaucrats.

In any event, the objectionable aspects of revised section 162(m) outweigh whatever good there may be in the new provision. The broadened cap on deductible pay almost certainly will fail to limit the amounts that public companies pay their executives. Corporations paid non-deductible compensation even when section 162(m) included established exceptions for nonqualified deferred compensation and performance-based compensation (Doran, 2017b; Kastiel and Noked, 2018). There is no good reason to think that they will change that practice now that all compensation over $1 million is non-deductible. And in fact, initial empirical evidence suggests that companies are largely indifferent to the effects of the broadened penalty tax under section 162(m) (De Simone *et al.*, 2022; Galle *et al.*, 2021; *cf.* Luna *et al.*, 2020).[15] Granted, executive-compensation arrangements are somewhat sticky, and it may be that new executive-pay equilibria will emerge over time. But five years after the changes to the $1 million cap, there is no evidence to suggest that companies will be more responsive to the broader cap than they were to the narrower cap (De Simone *et al.*, 2022).[16]

This points to a more serious problem. By definition, the disallowance of the deduction for compensation over the $1 million cap increases the corporation's tax liability (or decreases the corporation's net operating loss). Although the details remain uncertain, the burden of that increased tax liability falls on some combination of investors and workers. This of course is the familiar problem of the incidence of the corporate income tax. Although the corporation is the nominal taxpayer, the corporation is a legal fiction used to describe complicated contractual arrangements between and among natural persons such as investors, executives, directors, rank-and-file workers, consumers, and suppliers. As a legal fiction, the corporation cannot bear the burden of the corporate income tax; the tax necessarily is borne by natural persons (Auerbach, 2005; Nunns, 2012).

Beyond this basic point, however, there is little consensus about the incidence of the corporate income tax, although it is reasonably clear that both capital and labor bear a substantial portion of it (Auerbach, 2018; Gale and Thorpe, 2022; Nunns, 2012). The tax reduces the returns to shareholders and other investors, and it reduces the compensation paid to employees, whether they are executives or rank-and-file workers.[17] The important point here is that the increase in the corporate income tax attributable to the $1 million cap falls on investors and workers (Doran, 2017b; Walker, 2018), but these are precisely the persons in whose interest

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[15] In fact, one of the most pronounced effects of the 2017 change to section 162(m), at least in the short run, may have to accelerate the payment of performance-based compensation to avoid the effective date of the change (Durrant *et al.*, 2021).

[16] One study suggests that, in response to the repeal of the exception for performance-based compensation, companies have not shifted away from performance-based compensation but have shifted the underlying performance criteria from objective to subjective measures (Fox, 2021).

[17] To the extent that the corporate income tax is borne by investors, it is at least partly borne by investors in the non-corporate sector (Harberger, 1962).

the $1 million cap supposedly was enacted and then broadened. It is hard to see any policy justification for imposing a penalty tax on the very people said to be harmed by the penalized conduct. It is like giving a red card to a player who commits a foul and then ejecting the player against whom the foul was committed.

Perhaps, however, section 162(m) operates as a wage tax on amounts over $1 million, rather than as an increase in the corporate income tax? And perhaps, as a consequence, section 162(m) operates not so much to increase the tax burden on investors and workers as to decrease the compensation that otherwise would be paid to executives?[18] If so, that would offer a better policy justification for the $1 million deduction cap in general and for the 2017 broadening of the cap in particular. But the early empirical evidence indicates otherwise. Studies of executive pay after the 2017 reforms to section 162(m) (De Simone *et al*., 2022), earlier reforms to section 162(m) that targeted the health-insurance industry (Schieder and Baker, 2018), and legislation in Austria denying corporate deductions for executive compensation over €500,000 (Bornemann *et al.*, 2022) generally find no meaningful effects on the level of executive pay. These results are suggestive rather than conclusive. Still, based on the evidence available today, it appears that the expanded $1 million cap is indeed nothing more than a punitive increase in the corporate income tax – one borne primarily by investors and workers – rather than an effective constraint on executive pay.

In the end, section 162(m) must be put down as a policy failure. As enacted in 1993, section 162(m) distorted decisions about the components of executive compensation but had little or no discernible effect on the overall levels of executive compensation. As reformed in 2017, section 162(m) mitigates the distorting effects of the original statute. But the 2017 reform exacerbates the harsh effects on investors and workers who now must bear an even greater economic burden for executive-pay arrangements put into place by companies and executives.

[18] After all, corporations appear to pay executives at least a portion of their super-normal returns (Gale and Thorpe, 2022).

Conclusion

The two critical assumptions made by legislators over the past four decades when enacting tax rules directed at executive compensation are, first, that certain features of executive pay represent a failure of corporate governance and, second, that tax policy can correct that failure. The first assumption may or may not be correct; the theoretical and empirical arguments on this point remain unresolved. But the second assumption is increasingly untenable. Four decades of tax rules targeting executive compensation – the golden-parachute penalty taxes (section 280G), the $1 million deduction cap (section 162(m)), and the penalty taxes on nonqualified deferred compensation (section 409A) – have repeatedly undermined the assumption. The penalty taxes are largely ineffective in changing executive-compensation practices in the ways that legislators intend; in many instances, they actually exacerbate the features of executive pay that concern legislators in the first place. Most recently, the 2017 expansion of section 162(m) is a particularly misguided effort that likely will do little more than increase the economic burden of the corporate income tax on investors and rank-and-file workers.

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