November 12, 2013

www.citizen.org

Thanks a Billion (or So)

A Small Loophole Inserted 20 Years Ago Helps Companies Avoid Paying the U.S. Treasury Big Money

Acknowledgments

This report was written by Adam Crowther, Researcher for Public Citizen's Congress Watch division, and edited by Congress Watch Director Lisa Gilbert.

About Public Citizen

Public Citizen is a national non-profit organization with more than 300,000 members and supporters. We represent consumer interests through lobbying, litigation, administrative advocacy, research, and public education on a broad range of issues including consumer rights in the marketplace, product safety, financial regulation, worker safety, safe and affordable health care, campaign finance reform and government ethics, fair trade, climate change, and corporate and government accountability.

Public Citizen's Congress Watch
215 Pennsylvania Ave. S.E
Washington, D.C. 20003
P: 202-546-4996
F: 202-547-7392
http://www.citizen.org

© 2013 Public Citizen.

Introduction

Excessive executive compensation is not a recent cause of public outrage. In 1992, as the CEO-to-median worker pay ratio expanded to more than 200-to-1, then presidential candidate Bill Clinton campaigned on reigning in executive compensation, pledging to eliminate corporate tax deductions for pay that exceeded $1 million.[1] When Congress passed the first budget of the Clinton administration, the tax code was amended, placing a $1 million limit on the tax deductibility of certain types of an executive's compensation.

Twenty years later, in 2012, the ratio of CEO-to-median worker pay had soared to 354:1.[2] Meanwhile, corporations have avoided paying taxes on their executives' huge paychecks by paying them primarily on the basis of performance-based criteria, sometimes of questionable legitimacy. The top 20 highest-paid CEOs in the most recent version of the AFL-CIO's annual list of highest-paid CEOs were paid base salaries totaling $28 million, but had performance-based, tax-deductible compensation totaling more than $738 million, Public Citizen's analysis shows.[3] (A list of these CEOs and their compensation can be found in the Appendix.) If those CEOs' companies paid the statutory corporate tax rate of 35 percent, tax-deductible performance-based compensation for these CEOs cost American taxpayers $235 million in lost tax revenue.[4]

Background on Section 162(m)

In 1993, section 162(m) of the Internal Revenue Code was amended so that publicly traded corporations could deduct no more than $1 million for certain types of compensation, including but not limited to salary, cash bonuses, and equity awards.[5] However, this modification included two loopholes that allowed corporations to continue to deduct certain types of executive pay from their federal income taxes.

The new provisions of section 162(m) provided two exemptions to the $1 million deductibility limit. First, it exempted commission-based pay, which is defined as "any remuneration payable on a commission basis solely on account of income generated directly by the individual performance of the individual to whom such remuneration is

---

[1] Robert Reich, *Why We Should Stop Subsidizing Sky-High CEO Pay*, ROBERTREICH.ORG (July 17, 2013), http://bit.ly/14ev1Ve. See also *CEO Pay and You,* PAYWATCH (viewed November 5, 2013), http://bit.ly/10XoB7c.

[2] *CEO Pay and You,* PAYWATCH (viewed November 5, 2013), http://bit.ly/10XoB7c.

[3] *Top 100 Paid CEOs,* PAYWATCH (viewed November 5, 2013), http://bit.ly/17CJeut.

[4] Corporations whose income exceeds $18,333,333 are taxed at 35 percent. See *Federal Corproate Income Tax Rates, Income Years 1909-2012*, TAX FOUNDATION (viewed November 6, 2013), http://bit.ly/RsuiDT.

[5] SUSAN HOLMBERG AND LYDIA AUSTIN, ROOSEVELT INSTITUTE, FIXING A HOLE: HOW THE TAX CODE FOR EXECUTIVE PAY DISTORTS ECONOMIC INCENTIVE AND BURDENS TAXPAYERS 4 (July 2013), http://bit.ly/15STpI5.

payable."[6] Second, it exempted pay that is "payable solely on account of the attainment of one or more performance goals."[7] The latter is known as performance-based pay.

The latter exemption has several qualifiers. First, the performance goals must be established by a compensation committee of the board of directors. The compensation committee must be populated by two or more outside directors. Second, the material terms under which the executive is to be paid (including performance goals) must be disclosed to shareholders and approved by in a majority vote by shareholders before the executive is compensated. Third, before the executive is paid, the compensation committee must confirm that the performance goals and any other conditions were satisfied.[8] Performance-based pay is often said to be contingent on a quantifiable goal, such as stock prices, market share, revenues, and other measures.[9]

After section 162(m) was amended, a trend began in which many corporations altered their executive compensation packages to take advantage of a tax loophole that made it easy for corporations to deduct performance-based pay.[10]

Findings

The 20 highest paid CEOs of publicly traded corporations whose pay was analyzed by Public Citizen were paid base salaries totaling more than $28 million in 2012.[11] However, when their bonuses and other compensation are factored in, the CEOs' total compensation jumps to just under $1 billion. Of the nearly $1 billion distributed in total compensation, more than $738 million was designed to be performance-based and therefore tax deductible. Additionally, more than $155 million in non-deductible equity grants and bonuses was paid to executives in 2012. These CEOs were also paid more than $30 million in other compensation, including but not limited to company contributions to retirement plans, personal use of company property, and change in pension values. This analysis used compensation figures provided in the Summary Compensation Table of each company's proxy statement.

Many corporations do pay their executives a base salary above $1 million, increasingly the likelihood that they will incur some tax liability, regardless of how other compensation is

[6] I.R.C. § 162(m)(4)(b)

[7] I.R.C. § 162(m)(4)(c)

[8] I.R.C. § 162(m)(4)(c)(i-iii)

[9] SUSAN HOLMBERG AND LYDIA AUSTIN, ROOSEVELT INSTITUTE, FIXING A HOLE: HOW THE TAX CODE FOR EXECUTIVE PAY DISTORTS ECONOMIC INCENTIVE AND BURDENS TAXPAYERS 3 (July 2013), http://bit.ly/15STpI5.

[10] SUSAN HOLMBERG AND LYDIA AUSTIN, ROOSEVELT INSTITUTE, FIXING A HOLE: HOW THE TAX CODE FOR EXECUTIVE PAY DISTORTS ECONOMIC INCENTIVE AND BURDENS TAXPAYERS 1 (July 2013), http://bit.ly/15STpI5.

[11] The AFL-CIO analyzed 327 corporations in the S&P 500 and reported the total compensation for the 100 highest paid CEOs from those companies. See *Top 100 Paid CEOs,* PAYWATCH (viewed November 5, 2013), http://bit.ly/17CJeut.

structured. Leslie Moonves, the CEO of CBS Corp., was paid a base salary of $3.5 million, and David Zaslav, the CEO of Discovery Communications Inc., was paid $3 million. On average, the 20 CEOs whose pay was analyzed were paid just under $1.5 million in base salary in 2012.

The tax implications are obvious: because of the loopholes in 162(m), these 20 corporations could be avoiding as much as $235 million in federal corporate income taxes. A broader study of the S&P Capital IQ database conducted by Steven Balsam at the Economic Policy Institute discovered that in 2010, $27.8 billion of executive compensation was tax-deductible, which at variable corporate income tax rates resulted in between $4.2 and $9.7 billion of savings for the 7,248 corporations reviewed Balsam's study.[12]

Performance-Based Pay Is Sometimes a Sham

Some contractual pay clauses lay out such vague and ambiguous goals that they hardly deserve to be deemed performance-based.

For example, Robert A. Kotick, Blizzard Activision Inc.'s CEO, could collect a cash bonus equal to 200 percent of his base salary if the company achieves only 75 percent of its target operating income.[13]

The compensation committee for McKesson Corp. set target bonus awards at 80 percent to 150 percent of the CEO's base salary. However, the compensation committee reserved the right to add an individual modifier that would increase the bonus to 300 percent of salary, independent of any performance targets.[14]

One criterion for David Zaslav, the CEO of Discovery Communications Inc., was to "manage and support growth at Discovery Channel, TLC, and Animal Planet, emphasizing brand-defining content and enduring series."[15] No explanation for "growth" was provided.

Oracle Corp. established 23 different performance criteria that can be considered when granting equity awards to executives. However, the compensation committee can rely on just one of the 23 when determining if an executive will receive a grant, thereby giving the committee the ability to cherry-pick a positive outcome.[16] At Oracle's 2013 annual

---

[12] STEVEN BALSAM, ECONOMIC POLICY INSTITUTE, TAXES AND EXECUTIVE COMPENSATION 2 (August 2012), http://bit.ly/1apYSae.
[13] *2013 Def-14a Proxy Statement*, BLIZZARD ACTIVISION CORP. (viewed November 6, 2013), http://bit.ly/ZUAY2N.
[14] *2013 Def-14a Proxy Statement*, MCKESSON CORP (viewed November 6, 2013), http://bit.ly/1cMePv7.
[15] *2013 Def-14a Proxy Statement*, DISCOVERY COMMUNICATIONS INC. (viewed November 6, 2013), http://bit.ly/1861xpV.
[16] *2013 Def-14a Proxy Statement*, ORACLE CORP (viewed November 6, 2013), http://bit.ly/17xSHog.

shareholder meeting, Oracle's board of director's opposed a shareholder resolution both to include quantifiable performance metrics and to have them approved by shareholders.[17]

Conclusion

To address the unintended loophole in section 162(m), Congress should pass the Stop Subsidizing Multi-Million Dollar Corporate Bonuses Act. This legislation, introduced by U.S. Senators Jack Reed (D-R.I.) and Richard Blumenthal (D-Conn.), achieves several goals. First, it redefines what companies are covered by the provisions of 162(m) to include any corporation that qualifies as an issuer whose securities are registered under section 12 of the Securities Exchange Act of 1934 or is required to file reports under section 15(d) of the same law.[18] Previously, only publicly traded corporations whose securities were registered under the Securities Exchange Act were covered by 162(m). Second, it eliminates the tax exemption of commission-based pay. Third, and most importantly, it eliminates the performance-based compensation exemption to the $1 million deductibility cap.

[17] *2013 Def-14a Proxy Statement*, ORACLE CORP (viewed November 6, 2013), http://bit.ly/17xSHog.

[18] Press Release, Office of U.S. Sen. Jack Reed (D-R.I.), *Reed-Blumenthal Introduce the Stop Subsidizing Multi-Million Dollar Corporate Bonuses Act* (August 2, 2013), http://1.usa.gov/1cjVD81.

Appendix: Top 20 CEO Compensation, 2012

Company	CEO	Base Salary	Deductible, Performance-based Equity or Bonus Compensation	Non-Deductible Equity, Bonus, or Other Incentive Compensation	All other Compensation	Total Compensation
Oracle Corp	Larry Ellison	$1	$94,612,063	$0	1,548,632	$96,160,696
Tesla Motors Inc.	Elon Musk	$33,280	$78,110,730	$6,000	$0	$78,150,010
Gamco Investors Inc.	Mario J. Gambelli	$0	$68,970,486	$0	$0	$68,970,486
Activision Blizzard Inc	Robert A. Kotick	$2,006,127	$34,689,894	$28,180,135	$66,150	64,942,306
CBS Corp	Leslie Moonves	$3,513,461	$55,329,952	$0	$3,313,613	$62,157,026
Cheniere Energy Corp	Charif Souki	$781,063	$0	$56,610,000	$127,269	$57,518,332
Credit Acceptance Corp	Brett A. Roberts	$1,025,000	$53,250,000	$0	$7,500	$54,282,500
McKesson Corp	John H. Hammergren	$1,680,000	$27,562,256	$0	$362,508	$39,680,322
Discovery Communications Inc	David Zaslav	$3,000,000	$46,499,881	$0	$432,986	$49,932,867
HCA Holdings Inc	Richard M. Bracken	$1,387,474	$15,182,610	$0	$21,989,866	$46,359,246
Liberty Interactive Corp	Gregory B. Maffei	$778,641	$44,330,004	$0	$193,395	$45,302,040
Level 3 Communications Inc	James Q. Crowe	$1,155,269	$37,056,378	$2,100,000	$397,323	$40,708,970
Exxon Mobil Corp	Rex W. Tillerson	$2,567,000	$24,214,875	$0	$447,425	$40,266,501
Disney Co	Robert Iger	$2,500,000	$26,052,500	$7,750,008	$800,700	$40,227,848
Nuance Communications Inc	Paul A. Ricci	$794,423	$18,649,688	$17,449,688	$183,881	$36,283,256
Yahoo Inc	Marissa A. Mayer	$454,862	$0	$36,120,002	$40,540	$36,615,404
Ralph Lauren Corp	Ralph Lauren	$1,250,000	$29,766,875	$5,044,875	$264,032	$36,325,782
Nike Inc.	Mark G. Parker	$1,550,000	$33,354,186	$0	$308,492	$35,212,678
Pall Corp.	Lawrence Kingsley	$767,308	$22,778,915	$0	$171,457	$33,862,509
Viacom Inc.	Phillipe P. Dauman	$3,500,000	$27,774,310	$1,852,431	$269,363	$33,450,824
Total		*$28,743,909*	*$738,185,603*	*$155,113,139*	*$30,925,132*	*$996,409,603*

Source: Public Citizen analysis of 2012 and 2013 corporate proxy statements. Original list of highest paid CEOs derived from *CEO Pay and You,* PAYWATCH (viewed November 5, 2013), http://bit.ly/10XoB7c.