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ESSAY

IS THERE A ROLE FOR TAX LAW IN POLICING EXECUTIVE COMPENSATION?

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INTRODUCTION

The public often complains that executives of public corporations in the United States are overpaid.[1] Reports of average chief executive officer ("CEO") compensation in major American industrial companies exceeding $3.5 million[2] and of individual

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[1] *See* DEREK BOK, THE COST OF TALENT 95 (1993) (reporting survey results indicating that more than 75% of Americans find executive compensation levels to be excessive); Bevis Longstreth & Nancy Kane, *Shareholders' Growing Role in Executive Compensation* (pt.1), N.Y. L.J., Feb. 20, 1992, at 5 (characterizing the reaction to reports of executive compensation of " 'mind-numbing proportions' "). For a discussion of some reasons the issue of executive compensation has received so much public attention, see Irwin M. Stelzer, *Are CEO's Overpaid?*, 126 PUB. INT. 26, 26-33 (1997).

[2] *See CEOs Enjoy Fatter Bonuses This Year*, BOSTON GLOBE, Dec. 4, 1994, at A98 (reporting results of a survey undertaken by a compensation consulting firm indicating that in 1994 average CEO compensation in major American industrial companies was $3.56 million, as compared to $3.28 million in 1993). The median annual pay package for chief executive officers increased from $1.06 million (expressed in 1993 dollars) in 1983 to $1.92 million in 1993, greater than a 70% increase in real terms. *See* MARGARET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 9 (1995). If one considers only the two hundred largest American corporations, the figures are even higher. *See* Brian Dumaine, *A Knockout Year*, FORTUNE, July 25, 1994, at 94 (stating that 1993 compensation of the CEOs of the two hundred largest American corporations averaged $4.1 million).

CEOs earning compensation of $45 million or more[3] are met with the response that no one could be worth that much.[4] While attention has primarily been focused on CEO compensation, the pay packages of other senior executive officers have not gone unnoticed.[5]

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[3] *See* Dumaine, *supra* note 2, at 94 (reporting 1993 compensation of Sanford I. Weill of Travelers, Inc.). Widely reported examples of highly compensated CEO's of 1996 include: Lawrence Coss of Green Tree Financial, who earned a total compensation of $102.4 million; Andrew Grove of Intel, who earned $97.5 million; and Sanford I. Weill of the Travellers Group, who earned $94.1 million. *See* Jennifer Reingold, *Executive Pay*, BUS. WK., Apr. 21, 1997, at 58. From 1987 through 1993, almost 300 individual corporate executives earned more than $5 million in a given year and almost 100 earned more than $10 million. *See* BLAIR, *supra* note 2, at 88 (reporting that total annual compensation topped $20 million for 16 executives in 1992 and 1993).

[4] Compensation levels of CEOs and other high level executive officers have been characterized as "eye-popping," "breathtaking," and "scandalous." BOK, *supra* note 1, at 95. The reaction today parallels the reaction in 1939 to the Treasury Department's published list of American executives who earned more than $15,000 a year. At the height of the controversy caused by that publication, more than half of those surveyed in a public opinion poll felt that executives were overpaid and simply could not be worth $15,000 a year. *See* Andrew R. Brownstein & Morris J. Panner, *Who Should Set CEO Pay? The Press? Congress? Shareholders?*, HARV. BUS. REV. 28, 28-29 (1992). "There is unease and disquiet and a sense of concern [about] when is enough enough." Joann S. Lublin, *The Boss's Pay*, WALL ST. J., Apr. 10, 1997, at R1 (alteration in original) (quoting Abraham Zaleznik, retired Harvard business professor).

It is interesting that "[p]eople feel, instinctively, that if a movie studio pays a star $10 million for a single motion picture, the star must be worth that much, but the public is skeptical that the studio's CEO is worth $10 million for serving in that capacity for the year." Mark J. Loewenstein, *Reflections on Executive Compensation and a Modest Proposal for (Further) Reform*, 50 SMU L. REV. 201, 201 (1996).

[5] Other senior executive officers are also compensated generously. Total compensation for various non-CEO executives in 1996 include: $69,608,000 to Sam Wyly of Sterling Software; $50,865,000 to Frank Lanza of Lockheed Martin; and $37,697,000 to Richard Kinder of Enron. *See* Reingold, *supra* note 3, at 58. In 1996, a year when Bear Stearns' Chief Executive Officer, James E. Cayne, got a pay package in excess of $19 million, the company's chairman, Alan C. Greenberg, and its executive vice president, Warren J. Spector, also got packages of $19 million or more, and two other executive vice presidents, Alan D. Schwartz and Michael L. Tarnopol, received $14.6 million and $7.7 million, respectively. *See* Michael Siconolfi, *Bear Stearns' 5 Starters Get $81 Million, Beat NBA*, WALL ST. J., Sept. 17, 1996, at C1.

One reason for the large increase in executive compensation over the last decade is the move toward performance-based compensation, particularly stock options, which have generated huge returns over the last decade. *See* Brownstein & Panner, *supra* note 4, at 31. For example, John Reed of Citicorp earned a base salary of $4.3 million in 1995 and was awarded stock options amounting to $1.8 million (valued at grant). Reed's total compensation for 1995 was $6.1 million. However, in 1996, Reed's base salary was reduced to $3.5 million, but his compensation totaled $10.9 million. *See* Judith H. Dobrzynski, *New Road to Riches is Paid With Options*, N.Y.

When Americans have a complaint, they generally think something should be done to address that complaint. Frequently, they think the government should be the one to solve the problem. One of the ways in which the federal government has been involved in the area of executive compensation is through the Internal Revenue Code (the "Code"), which imposes limits on the deductibility of both ordinary compensation and compensation contingent on a change in corporate control. Several months ago, the Internal Revenue Service (the "IRS") initiated a case in the United States Tax Court in Washington D.C. against Columbia/HCA Healthcare Corp., alleging that the company owed $190 million in back taxes for "unreasonable compensation" and "excess parachute payments."[6] So rarely has the IRS attacked a major public company's deductions for executive pay,[7] that some believe the case telegraphs the IRS's "intent to open a new chapter in their policing of compensation in public companies."[8] In addition to whatever actions the IRS takes under current law, there have also been proposals made in the last several years to use the Code more extensively to alter corporate decisions on executive compensation.[9]

This Essay examines whether there is a role for the Code in the policing of compensation paid to executives of public corporations[10] in the United States. Part I examines attempts under

TIMES, Mar. 30, 1997, § 3, at 1; *see also* BLAIR, *supra* note 2, at 92 (explaining that the large pay increases in the last 10 years are the result of the shift toward the use of stock options; stock options are the largest component of long-term compensation, and in nearly every case where total compensation in 1992 exceeded $5 million, a significant portion of the income was attributable to the exercise of stock options); Brownstein & Panner, *supra* note 4, at 31 (arguing that, if one examines "some of the most controversial pay packages, it is the stock element rather than base pay that accounts for the largest total compensation amounts"); Daniel Kadlec, *How CEO Pay Got Away*, TIME, Apr. 28, 1997, at 59 (declaring that the packages that give "astronomical amounts" to CEOs are those heavily composed of stock options).

[6] Joann S. Lublin & Lucette Lagnado, *Columbia Tax Fight Could Set Pay Precedents*, WALL ST. J., Aug. 11, 1997, at B1 (according to papers filed by IRS in U.S. Tax Court).

[7] This case is "one of the rare times" that the IRS has instituted an action regarding a "major public company's deductions for executive pay," and is the largest claim ever involving a public concern's executive pay deductions. *Id.* at B5.

[8] *Id.* (quoting Robert Salwen, president of New York consulting firm, Executive Compensation Corp.).

[9] *See* Brownstein & Panner, *supra* note 4, at 34 (discussing a bill proposed by former Congressman Martin Sabo to disallow tax deductions for excessive executive salaries).

[10] Corporate law scholarship has sometimes been criticized for focusing too heavily on publicly-held corporations, to the exclusion of closely held businesses,

current law to use the Code as a means of addressing perceived abuses in executive compensation. Part II examines whether the Code should be used as a vehicle for policing executive compensation. The conclusion of this Essay is that the Code should not be used as a means of attempting to influence the amount or type of compensation a company pays its executives in absolute terms or in relation to the compensation a company pays its rank and file employees. Unless Congress and the IRS are able to articulate and defend a different goal in relation to executive compensation, there is no role for the Code in this area.

I. CURRENT ATTEMPTS TO USE THE CODE AS A MEANS OF POLICING EXECUTIVE COMPENSATION

Section 162(a)(1) of the Internal Revenue Code permits a taxpayer to take a deduction for "ordinary and necessary" business expenses, including "a reasonable allowance for salaries or other compensation for personal services actually rendered."[11] Treasury Regulations promulgated under section 162 expand the statutory language by providing that the "test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services."[12] Although the Regulations seem on their face to envision a two-part test, in reality, the primary inquiry is whether the amount of compensation in question is reasonable, since courts will infer from that

through which much of the commerce in this country is carried on, and to the exclusion of other forms of organizations. *See, e.g.*, Carl Landauer, *Beyond the Law and Economics Style: Advancing Corporate Law in an Era of Downsizing and Corporate Reengineering*, 84 CAL. L. REV. 1693, 1695-96, 1705 (1996). Although focusing on publicly-held corporations ignores a significant amount of business in this country, when discussing executive compensation, the focus on publicly-held corporations is a sensible one. Unlike publicly-held corporations, closely-held corporations are generally run by the investing shareholders. Thus, they more closely resemble partnerships than publicly-held corporations, meaning there is less need than in a publicly-held corporation to be concerned with parties' allocations of compensation and profit. Additionally, because compensation in closely-held corporations is often a vehicle to transfer investment returns to shareholders, the IRS is an aggressive monitor of compensation in privately-held entities. *See infra* note 15 and accompanying text.

[11] 26 U.S.C. § 162(a)(1) (1994).

[12] Treas. Reg. § 1.162-7(a) (1997). In making the determination whether compensation is reasonable, the Regulations explain that a reasonable amount is one that would result from an arms-length bargain between the employer and the employee and that reasonable compensation is limited to the amount that would ordinarily be paid by an enterprise under like circumstances. *See id.* §1.162-7(b).

conclusion the existence of a compensatory purpose.[13]

Section 162(a)(1) appears to operate as a restriction on the amounts that may be paid to executives. The language of the statute and the regulations certainly gives the IRS the authority to disallow deductions for compensation that is viewed to be unreasonable. The IRS, however, has not aggressively utilized this authority. There are few cases, none of them recent (with the exception of the recently initiated action against Columbia/HCA Healthcare Corp.), in which the IRS has challenged compensation paid to executives of publicly-held companies.[14] IRS efforts to disallow deductions for compensation have generally been targeted at close corporations, where the executive is essentially setting her own salary and the allegation is that the amounts paid are unreasonable or are really disguised dividends and not compensation.[15] Although it is conceivable that the IRS's at-

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[13] *See* Clymer v. Commissioner, 47 T.C.M. (CCH) 1576, 1576, *aff'd by* Denison Poultry & Egg Co. v. Commissioner, 47 TCM (CCH) 1576 (1984); Elliots, Inc. v. Commissioner, 716 F.2d 1241, 1244-45 (9th Cir. 1983), *aff'd by* Elliots, Inc. v. C.I.R. Serv., 899 F.2d 1051 (9th Cir. 1986).

[14] Four examples of cases involving challenges to compensation paid in publicly-held corporations include: R.J. Reynolds Tobacco Co. v. United States, 149 F. Supp. 889 (Ct. Cl. 1957), *aff'd*, 260 F.2d 9 (4th Cir. 1958); Brown-Forman Distillers Corp. v. United States, 132 F. Supp. 711 (Ct. Cl. 1955); Pfeifer Brewing Co. v. Commissioner, 11 T.C.M. (CCH) 586 (1952); and Patton v. Commissioner, 168 F.2d 28 (1948). In two of the cases, *Pfeifer Brewing Co.* and *Brown-Forman Distillers Corp.*, compensation was found to be reasonable. *See Pfeifer Brewing Co.*, 11 T.C.M. (CCH) at 597 and *Brown-Forman Distillers Corp.*, 132 F. Supp. at 717. The third, *R.J. Reynolds Tobacco Co.*, was not so much an issue of excessive compensation as it was a claim that the method for allocating stock under a bonus arrangement made the stock distribution more like a dividend than a compensation payment. *See R.J. Reynolds Tobacco Co.*, 260 F.2d at 12. The final case, *Patton*, involved a suspicion that the employer and not the employee actually kept the compensation. *See Patton*, 168 F.2d at 29.

[15] *See* RTS Inv. Corp. v. Commissioner, 877 F.2d 647 (8th Cir. 1989), *aff'd by* Holt v. C.I.R., 899 F.2d 1225 (9th Cir. 1990); Owensby & Kritikos, Inc. v. Commissioner, 819 F.2d 1315 (5th Cir. 1987); Trinity Quarries, Inc. v. United States, 679 F.2d 205 (11th Cir. 1982); Kennedy v. Commissioner, 671 F.2d 167 (6th Cir. 1982); *see also* GRAEF S. CRYSTAL, IN SEARCH OF EXCESS 89 (1991) (concluding that the IRS only gets involved in situations where a small number of executives own all, or almost all, of a company's shares and are in a position to engage in self-dealing); Detlev Vagts, *Challenges to Executive Compensation: For the Markets or the Courts?*, 8 J. CORP. L. 231, 257 (1983) (stating that the primary motivation of the IRS in pursuing corporate compensation cases is to prevent owner-entrepreneurs from passing to themselves, in the guise of deductible salary, non-deductible dividends); Charles A. Barragato, *Sustaining a Deduction for Reasonable Compensation*, 61 CPA J. 10 (May 1991) ("The IRS salivates over the prospects of unreasonable compensation to the employee/shareholder.").

There is some support in the section 162 regulations for the IRS's position. The tempt to recover back taxes from Columbia/HCA Healthcare Corp. could indicate an intent on the part of the IRS to be more aggressive in challenging pay in public corporations, this is unlikely. That case involved a peculiar fact pattern of options granted to executives and managers as part of a management-led leveraged buyout and involved claims of violations of section 280G of the Code.[16] There is nothing in that case that indicates an intent by the IRS to use section 162 to challenge compensation of public corporations in ordinary settings.

In 1993, as part of the Omnibus Revenue Reconciliation Act,[17] Congress amended section 162 to provide that annual compensation paid to the CEO and the four other highest paid officers of public companies which exceeds $1 million may not be deducted as an ordinary and necessary business expense.[18] The

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regulations specifically mention that an "ostensible salary paid by a corporation may be a distribution of a dividend on stock." Treas. Reg. § 1.162-7(b)(1) (1997). The Regulations also suggest that this is likely to occur in the case of close corporations. *See id.* Finally, Treasury Regulation § 1.162-7(a)(2) states that contingent payment contracts made pursuant to a free bargain will generally not be challenged even though the amounts turn out to be unusually large.

[16] *See* Lublin & Lagnado, *supra* note 6, at B5. The stock options in question were granted to 111 executives and managers and resulted in $426 million in deductions. *See id.* For a discussion of section 280G, see *infra* text accompanying notes 28-43.

It is also not clear to what extent, if any, the IRS's decision to go after Columbia/HCA Healthcare is related to the ongoing investigation by the federal government and at least eleven states into the company's Medicare billing practices. *See, e.g., Columbia/HCA Case Lopsided, Lawyer Says*, USA TODAY, Sept. 22, 1997, at 8B.

[17] Pub. L. No. 103-66, § 13211, 107 Stat. 312, 469-71 (Aug. 10, 1993).

[18] 26 U.S.C. § 162(m)(1) (1994). "In the case of any publicly held corporation, no deduction shall be allowed under this chapter for applicable employee remuneration with respect to any covered employee to the extent that the amount of such remuneration for the taxable year with respect to such employee exceeds $1,000,000." *Id.* For purposes of the $1,000,000 limit, "publicly held corporation" means any corporation that has a class of securities that are required to be registered under section 12 of the Securities Exchange Act of 1934. *See* 26 U.S.C. § 162(m)(2) (1994).

It is clear that § 162(m) "was not intended to be a revenue-raising provision, but a behavior-shaping provision. The exception for performance-based compensation 'is not a loophole.' " Megan M. Reilly, *Former Treasury Official Discusses Executive Compensation Cap*, 62 TAX NOTES 747 (Feb. 3, 1994) (citing Catherine Creech, former Treasury benefits tax counsel). In fact, Congress' estimates of the additional tax revenue that would be generated in 1995 as a result of 162(m) was only $55 million. *See* STAFF OF JOINT COMM. ON TAXATION, 103D CONG., 1st SESS., ESTIMATED BUDGET EFFECTS OF THE REVENUE PROVISIONS OF H.R. 22641 (Comm. Print 1993). Thus, Congress' aim in enacting § 162(m), along with its exception for performance-based pay was to encourage performance-based compensation. *See id.*; *see also Executive Compensation Hearings on S.2298, H.R. 4727 and H.R. 5260 Before the Sub-*

$1 million limit on deductibility is subject to a number of exceptions, including an exception for compensation that hinges on the "attainment of one or more performance goals."[19] Such compensation is excepted from the statutory limit so long as such goals are established by a compensation committee composed of outside directors, approved by shareholders, and certified by the company's compensation committee as having been met.[20]

Despite the hype during the 1992 Presidential campaign that preceded President Clinton's recommendation to cap the deductibility of compensation,[21] section 162 will have little effect

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comm. on Taxation of the Senate Comm. on Finance, 102d Cong. 2 (1992) (statement of Sen. Boren) ("[W]e would be less concerned about the amount of compensation paid to executives if we believed that pay tracked performance."); H.R. REP. NO. 103-111, at 646 (1993), *reprinted in* 1993 U.S.C.C.A.N. 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.").

[19] 26 U.S.C § 162 (m)(4)(C) (1994).

[20] *See id.* Regulations adopted in 1995 clarify that a preestablished performance goal "must state, in terms of an objective formula or standard, the method for computing the amount of compensation payable to the employee if the goal is attained." Treas. Reg. § 1.162-27(e)(2)(ii) (1994). The Regulations also prohibit discretion to increase the amount of compensation to be paid under the preestablished performance goal. *See* Treas. Reg. § 1.162-27(e)(2)(iii)(A) (1994). The Treasury Regulations provide examples of performance goals such as making a certain settlement in litigation and bonuses contingent on achieving specific sales or profit goals. *See* Treas. Reg. § 1.162-27(e)(2)(vii) (1997). Further, performance goals might include, for example, a goal to adhere to the status quo or not to lose money. *See* Reilly, *supra* note 18, at 747; *see also infra* note 25.

There are exceptions to the operation of section 162(m) other than the exception for performance-based compensation. The $1 million deduction limit does not apply to compensation paid by a privately-held corporation or to compensation paid under a plan or agreement that existed while a corporation was privately-held, even if the company subsequently becomes publicly-held. *See* 26 U.S.C. § 162(m)(1) (1994); Treas. Reg. § 1.162-27(f) (1997). The privately-held exception is a reasonable one because the IRS is more willing to challenge compensation as disguised dividend in that context. In addition, it only covers compensation paid to the CEO and the other four most highly paid executives (i.e., those executives whose compensation must be reported to the Securities and Exchange Commission and publicly disclosed in proxy materials). *See* 26 U.S.C. § 162(m)(3) (1994). And even those executives are subject to the limit only if they are employed on the last day of the corporation's taxable year. *See* Treas. Reg. § 1.162-27(c)(2)(i) (1994). The $1 million limit also does not include employee remuneration that is payable "on a commission basis solely on account of income generated" by the officer's performance, 26 U.S.C. § 162(m)(4)(B) (1994), and certain income agreed to or deductible prior to 1994. *See* 26 U.S.C. § 162(m)(4)(D) (1994). *See generally* Kevin J. Ryan, *Rethinking Section 162(m)'s Limitation on the Deduction of Executive Compensation: A Review of the Commentary*, 15 VA. TAX. REV. 371 (1995) (discussing the mechanics of, and exceptions contained in, section 162(m)).

[21] *See, e.g.*, Amanda Bennett, *Clinton Victory Wouldn't Slash Top Officer Pay*,

on the amount paid to executives. First, some companies who wish to pay salaries in excess of $1 million will simply ignore the statutory limit and do without the tax deduction for the excess.[22] Second, even for those companies for whom preserving the deduction is important, the performance-based compensation exception to the $1 million limit renders section 162(m) virtually meaningless. As a result of the public attention focused on the compensation of executives, large public corporations have already shifted away from high base salaries and assured annual bonus pay, and towards performance-based compensation.[23] Income from stock options,[24] the most popular form of performance-based compensation, will by definition be excluded from the $1 million limit, as will most amounts paid pursuant to short-term

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WALL ST. J., Nov. 3, 1992, at B1 (discussing Clinton plan to eliminate corporation tax deduction on executive pay in excess of $1 million).

[22] *See id.* (stating that companies are more likely to choose to forego the deduction than to cut compensation); Michelle L. Johnson, *Forget the Rhetoric - Executive Pay Fell For Many in '91*, INV. BUS. DAILY, Mar. 13, 1992, at 8 (noting that limiting deduction for compensation will result in a double hit to shareholders because companies will opt to give up the tax deduction); Joann S. Luben, *Firms Forfeit Tax Break to Pay Top Brass $1 Million-Plus*, WALL ST. J., Apr. 21, 1994, at B1 (reporting that an examination of proxies of 91 large companies by consultants Pearl Meyer and Partners, Inc. reveals that about one-third of the companies have decided to pay what they want and do without the deduction rather than seek shareholder approval for certain pay plans or keep compensation at the $1 million limit); *The Boss's Pay*, WALL ST. J., Apr. 11, 1996, at R15 (citing to a review of 1995 proxy statements by compensation consultant William M. Mercer, which noted that only 38 of 350 companies surveyed paid a base salary in excess of $1 million).

[23] *See* BOK, *supra* note 1, at 108 (1993) (stating that CEOs of Fortune 500 companies receive about 75% of their annual compensation in bonuses, stock options, restricted stock and other forms of performance-related pay); Linda J. Barris, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay*, 68 IND. L.J. 59, 64 (1992) (illustrating that long-term incentive compensation accounted for a third of total CEO pay in 1991, compared to 8% in 1985); Jack L. Lederer & Carl R. Weinberg, *Harnessing Corporate Horsepower: The New Principles of CEO Compensation*, CHIEF EXEC. 32 (Sept. 1, 1995) (discussing that Chief Executive's annual corporate survey reveals an increase in the number of CEOs accepting both pay-for-performance and more substantial downside risk).

[24] A stock option grants the holder of the option the right (but not the obligation) to purchase a number of shares of company stock at a price that is fixed at the date of grant. That price, the option exercise price, is typically the fair market value on the date of grant of the shares subject to the option. Generally, options become exercisable over time and when they become exercisable, they remain so for a period of usually ten years. *See generally* Joseph Bankman, *The UCLA Tax Policy Conference: The Structure of Silicon Valley Start Ups*, 41 UCLA L. REV. 1737, 1750 (1994); Michael W. Melton, *Symposium: The Economic Recovery Tax Act of 1981: The Alchemy of Incentive Stock Options—Turning Employee Income Into Gold*, 68 CORNELL L. REV. 488, 492-93 (1983).

incentive plans.[25] Base compensation and guaranteed bonuses will be all that is covered. Thus, companies wishing to preserve the compensation deduction can structure their compensation arrangements so that the largest portion thereof is excluded from the limit.

As a result, according to IRS figures, not only has section 162(m) not resulted in a decrease in executive compensation, but "executive pay actually rose 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."[26] From 1994 to 1995, corporate deductions for executive pay increased more than 9.1%, compared with an average increase of 7% between 1980 and 1994.[27]

Another provision regulating executive compensation is section 280G of the Code, enacted as part of the Deficit Reduction Act of 1984,[28] which aims at imposing some limit on golden parachutes.[29] It has become commonplace for companies to offer executives quite generous severance packages[30] and payments

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[25] Short-term incentive compensation plans generally provide for an annual payment to executives based on certain measures of company and individual performance during the previous year. Generally, such a plan will establish benchmarks for performance in certain categories, such as earnings per share, return on assets or return on equity. If the company achieves those benchmarks, a certain bonus is paid. If the benchmark is exceeded, a larger bonus is paid; if it is not met, either a smaller or no bonus is paid. *See generally* IRA R. KAY, VALUES AT THE TOP: SOLUTIONS TO THE EXECUTIVE COMPENSATION CRISIS 189 (1992); William E. Lissy & Marlene L. Morgenstern, *Current Trends in Compensation & Benefits*, 27 COMP. & BEN. REV. 10 (1995).

[26] David Cay Johnston, *Executive Pay Increases at a Much Faster Rate Than Corporate Revenues and Profits*, N.Y. TIMES, Sept. 2, 1997, at D4.

[27] *See id.* (quoting IRS figures); *see also* Ryan, *supra* note 20, at 396 (concluding that the impact of section 162(m) "thrusts" inefficiency and excess in corporate governance into American business).

[28] Pub. L. No. 98-369, § 67, 98 Stat. 494 (1984) (codified at 26 U.S.C. § 280G, 4999).

[29] A golden parachute is an executive termination agreement between an executive and his corporation providing special enhanced severance benefits in the event an executive is terminated as a result of a hostile takeover of the corporation. Frequently, such agreements provide for a large cash payment and accelerated vesting for any outstanding stock options and stock bonus grants as well as other fringe benefits, such as continued insurance benefits for some period of time. *See* R. WINTER, ET AL., SHARK REPELLENTS AND GOLDEN PARACHUTES 425-28 (1983).

[30] *See* Nikhil Deogun, *Delta to Pay Sum of $4.5 Million to Former Chief*, WALL ST. J., Sept. 23, 1997, at B12 (reporting that Delta paid its former chairman, president, and CEO a lump-sum severance payment of $4.5 million); *see also* *News: Analysis & Commentary: Where Parting is Such a Sweet Deal*, BUS. WK., Mar. 31, 1997, at 42 (citing numerous examples of rich severance arrangements, including

made to those executives who terminate employment in connection with a change in control are even more extravagant.[31] Section 280G aims at controlling the latter.[32]

Section 280G dictates that a payment contingent on a change in ownership or effective control of the corporation or in the ownership of a substantial portion of the corporation's assets that provides an executive with payments greater than or equal to three times the executive's total annual compensation is presumed excessive for tax purposes.[33] As a result, the corporation

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Phillip B. Rooney, who will receive $2.5 million in each of the next five years after stepping down as CEO of WMX Technologies Inc. due to pressure from investor George Soros; John W. Amerman, who upon retiring as CEO of Mattel Inc. received a special achievement award of $370,000 and was named a part-time senior advisor to the new CEO, with a remuneration of $1.1 million a year; Roy R. Irani of Occidental Petroleum Corp., who in 1991 negotiated a deal that will pay him 50% of his highest annual compensation, including salaries, bonus and restricted stock, to be paid for life, commencing upon retirement; and Joel B. Alvord, who, upon losing his position as Shawmut National Corp. CEO as a result of Fleet Financial's purchase of Shawmut, received a severance package of $15.5 million in cash and options as well as a $1.5 million payment in 1996). The *Business Week* article cites Carol Bowle, editor of *Executive Compensation Reports,* who stated that the amounts currently being awarded to departing executives are a measure of what the market will bear. *See id.* Another suggestion is that lavish severance arrangements are the result of greater job insecurity at the executive level. *See id.*

Some of these generous severance arrangements are difficult to understand, since they involve forcible terminations. *See* ANDREW HACKER, MONEY: WHO HAS HOW MUCH AND WHY 112 (1977) (stating that Borden's board gave an ousted CEO an extra 100,000 stock options and W.R. Grace provided its ousted CEO with an $849,000 annual pension for life); Denise Caruso, *Technology: Digital Commerce: Apple's Executive MacMath: The Greater the Loss, the Greater the Salary,* N.Y. TIMES, July 14, 1997, at D5 (describing a series of lavish severance payments to deposed Apple CEOs, including a $3 million severance package for John Sculley; between $3 and $4 million paid to Michael Spindler, "who presided over one of the company's steepest declines," and, more recently, about $7 million to be paid to the most recently terminated CEO, Amelio).

[31] *See* H.R. REP. NO. 98-861, *reprinted in* 1984 U.S.C.C.A.N. 843-47; *infra* text accompanying notes 38-39; *see also* Henry F. Johnson, *Those "Golden Parachute" Agreements: the Taxman Cuts the Ripcord,* 10 DEL. J. CORP. L. 45, 51 (1985) (detailing the argument that payments relating to changes of control are a waste of corporate assets).

[32] *See* DEFICIT REDUCTION ACT OF 1984, STAFF OF SENATE COMM. ON FINANCE, 98TH CONG., 2D SESS., EXPLANATION OF PROVISIONS APPROVED BY THE SENATE COMM. ON FINANCE ON MAR. 21, 1984, 175, 195-96 (Comm. Print 1984); GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, H.R. 4170, 98TH CONG., 2D SESS. 174, 199-207 (Joint Comm. Print 1984); H.R. CONF. REP. NO. 98-861, *reprinted in* 1984 U.S.C.C.A.N. 1445, 1537-42; *see also* Johnson, H., *supra* note 31, at 56-60 (stating that Tax Reform Act of 1984 (including section 280G) imposes penalties upon excessive compensation packages that "are triggered as a result of a change in corporate ownership").

[33] *See* 26 U.S.C. § 280G(b)(2)(A) (1994).

loses its deduction for the golden parachute payments and a 20% excise tax is imposed on the executive receiving the payment.[34] The aim of section 280G is to make excessive parachute payments financially prohibitive to a corporation.[35]

Whatever one thinks of the merits of limiting golden parachute payments,[36] section 280G is of limited effect for several

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[34] *See id.* §§ 280G & 4999.

[35] Congress had two thoughts in enacting section 280G. Congress was concerned both that the existence of lucrative golden parachute agreements discouraged takeovers, resulting in management entrenchment, and that the potential receipt of a generous parachute payment might cause management to favor a takeover not in the best interests of shareholders. *See* STAFF OF JOINT COMM. ON TAXATION, 98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 199 (Comm. Print 1984); *see also* Jonathan R. Macey, *Wealth Creation as "Sin,"* 17 CORP. BD. 12 (July 17, 1996) (arguing that section 280G focuses on remedying a perceived corporate governance problem rather than refining the definition of "ordinary and necessary" business expense).

[36] Section 280G has its critics. "Golden parachutes" are defended by some as a tool facilitating the attraction and retention of good executives, maximizing the effectiveness of the corporation's financial investment in future employment security, promoting objectivity among executives, particularly when faced with a threat of a change in control, and discouraging attempts by employees to block takeovers as well as unfriendly takeover attempts of well-managed companies by inefficient bidders. *See* John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 75-76 (1986) (explaining the benefits of the golden parachute approach as compared to the general grant of risk premiums and contractual protections to the corporation's management); Johnson, H., *supra* note 31, at 47-55 (outlining the arguments advanced by golden parachute proponents, including the retention of well-qualified executives and the elimination of personally-biased and subjective executive decisions); Kenneth C. Johnson, *Golden Parachutes and the Business Judgment Rule: Toward a Proper Standard of Review*, 94 YALE L.J. 909, 914-18 (1985) (highlighting the economic benefits and general effectiveness of golden parachute agreements); Drew Harrison Campbell, Note, *Golden Parachutes: Common Sense from the Common Law*, 51 OHIO ST. L.J. 279, 282 (1990) (describing the effects of the golden parachute in maximizing the objectivity of corporate executives and in promoting the interests of shareholders). In addition, the fact that stock prices increase by an average of 3% when a company announces the adoption of a golden parachute provision "supports the contention that golden parachutes benefit shareholders by removing managers' incentives to block economically efficient takeovers." Kevin J. Murphy, *Top Executives are Worth Every Nickel They Get*, HARV. BUS. REV., Mar.-Apr. 1986, at 125, 128. *But see* Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 285 n.114 (1984) (arguing that golden parachutes "create a perverse incentive [because] ... [t]he employee-manager may be better off if an acquisition takes place[,] even on terms that make the shareholder worse off"); Johnson, H., *supra* note 31, at 50-55 (suggesting that the arguments in favor of golden parachutes are flawed and that such agreements are more detrimental than beneficial); David W. Leebron, *Games Corporations Play: A Theory of Tender Offers*, 61 N.Y.U. L. REV. 153, 183 n.105 (1986) (positing that golden parachute arrangements effectively reduce the tendency of management to strongly bargain over terms, leading invariably to less frequent

reasons. First, it affects only payments that are contingent on a change in control. Therefore, it affects only a small percentage of compensation payments. Moreover, section 280G may be counterproductive if the goal of the section is limiting compensation. Fear of triggering the loss of deduction and imposition of an excise tax may prompt companies to pay executives more in the form of signing bonuses or increased annual income instead of providing for payments contingent on a change in control.[37] Since change in control payments may never get triggered, replacing them with guaranteed payments actually increases compensation costs to the company.

Second, section 280G contains a number of exceptions even with respect to compensation that is contingent on a change in control. The statute does not penalize payments in excess of three times the executive's compensation which are established by clear and convincing evidence to be reasonable compensation.[38] Additionally, payments under qualified plans and options granted more than one year prior to a change in control are excluded.[39]

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opposition and a decrease in acquisition prices).

[37] *See* Johnson, H., *supra* note 31, at 63 (suggesting that employers may be encouraged by section 280G either to guarantee an executive continued employment or to grant top prospects cash bonuses "up front" as additional consideration for accepting a job with the corporation). Professor Johnson also suggests that corporations could avoid the application of section 280G by establishing sizable annuities for key executives. *See id.* at 63-64. This is possible because of the exclusion from the operation of section 280G for payments made to or from a qualified pension, profit-sharing, stock bonus, or annuity plan. *See* 26 U.S.C. § 280G(b)(6) (1997).

[38] Though all payments under a golden parachute agreement are presumed excessive, that presumption is rebuttable. *See* 26 U.S.C. § 280G(b)(4) (1994). The drafters of the legislation did not believe that it would be easy to demonstrate that parachute payments constitute reasonable compensation. *See* H.R. CONF. REP. 98-961, at 757, 852 (1984), *reprinted in* 1984 U.S.C.C.A.N. 1445, 1540 (indicating that the drafters contemplated that only in rare cases, if any, would any portion of a parachute payment be treated as reasonable compensation).

The view of the courts on this matter is unclear, though the courts clearly place the burden of proof on the taxpayer to demonstrate reasonableness. *See* Cline v. Commissioner, 34 F.3d 480, 487-88 (7th Cir. 1994) (noting that payment was not reasonable compensation because the executives failed to establish the granting of bonuses and increases in payments in the past); Balch v. Commissioner, 100 T.C. 331, 349 (1993) (explaining that the petitioners failed to establish by clear and convincing evidence that the payment was reasonable compensation by considering three critical factors: the history of the individual's compensation, the contractual duties, and comparable compensation in a non-acquisition setting).

[39] *See* 26 U.S.C. § 280G(b)(6) (1994); *see also* Susan Lorde Martin, *The Executive Compensation Problem*, 98 DICK. L. REV. 237, 245-46 (1994) (criticizing the exclusion of parachute payments).

The amount executives have received under golden parachute agreements in the years since the enactment of section 280G provides the ultimate evidence of the limited effect of the statute. As an illustration, the leveraged buyout of RJR Nabisco in 1988 resulted in golden parachute payments of $53,800,000 to Chief Executive Officer F. Ross Johnson, $45,700,000 to Vice Chairman E.A. Horrigan, and $18,200,000 to Executive Vice President John D. Martin.[40] In the same year, the takeover of Primerica by Commercial Credit resulted in golden parachute payments of $46,800,000 to Primerica's Chairman, Gerald Tsai, Jr., and $18,400,000 to its President, Kenneth A. Yarnell.[41]

There is evidence that not only have many corporations foregone the deduction, but a number have also added a "gross up" to the compensation paid to executives to take account of the tax imposed by section 280G; that is, they increase the payment made by an amount equal to the taxes that the executive will be required to pay.[42] Thus, instead of eliminating or minimizing golden parachutes, the effect of the tax imposed by section 280G is to make such payments more expensive to the corporations. Therefore, neither with respect to ordinary compensation nor with respect to compensation contingent on a change in control has the Code proven a very meaningful curb on executive compensation.[43]

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[40] *See* KEVIN PHILLIPS, THE POLITICS OF RICH AND POOR 182 (1991).

[41] *See id.*

[42] *See* Tate & Lyle v. Staley Continental, Inc., No. CIV.A. 9813, 1988 WL 46064, at *3 (Del. Ch. May 9, 1988) (discussing tax "gross-ups" with the effect of compensating parachute beneficiaries for the federal excise tax and adding $13.8 million in cost to the corporation); Brownstein & Panner, *supra* note 4, at 34; Martin, *supra* note 39, at 246 (asserting that there is "no reason to expect that corporations would be unwilling to forego the corporate deduction and increase the payment to corporate officers to offset the excise tax"); Ellen E. Schultz, *More-Equal Benefits Go to Some Top Executives*, WALL ST. J., May 25, 1993, at C1, C17 (stating that companies will restore lost benefits when government puts limits on executive compensation).

[43] There are several other tax code provisions that have some effect on compensation paid to executives. With respect to pensions, there are limits on the amount of a pension benefit which can be provided to executives under tax-qualified pension plans. The Code limits how much compensation will be considered for purposes of calculating pension benefits, how many benefits may be paid by pension plans and how much executives can save for retirement on a tax-deferred basis. *See* 26 U.S.C. § 415(b) (1994) (imposing limits on contributions to and benefits paid by pension plans); *id.* § 402(g) (imposing limits on elective deferrals an individual can exclude from gross income in any year); *id.* § 401(a)(17) (limiting how much compensation can be considered in the calculation of pension benefits). Additionally, the Code limits the amount of incentive stock options, those which receive favorable tax treat-

II. SHOULD WE USE THE TAX CODE AS A WAY TO POLICE EXECUTIVE COMPENSATION?

The Code contains both a general reasonableness limit on deductibility of compensation paid to executives and several specific provisions that limit deductibility. It is clear that these limits are not now operating to affect executive compensation in a significant way. The question is whether the Code can and should serve as a more aggressive constraint. In order to answer that question, Congress' goals in this area must be identified. Then both the goals and the ability of the Code to achieve them can be evaluated.

Before examining any non-revenue raising goals Congress may have in this area, it is necessary to address the claim made by some commentators that the Code is merely intended as a revenue-raising document and is not a "proper venue for the implementation of social policy."[44] Such a claim is simply unsupportable. There are numerous instances of the Code being used to shape social policy, ranging from the adoption tax credit,[45] with its goal of promoting adoptions, particularly of minority children,[46] the targeted jobs tax credit,[47] with its goal of providing job opportunities for certain disadvantaged groups,[48] the low-

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ment, that can be exercised in any one year. *See* 26 U.S.C. § 422(d). Although these provisions will have an effect on the individual components of executive compensation, they are not likely to affect the overall level of compensation.

[44] Ryan, *supra* note 20, at 372.

[45] *See* 26 U.S.C. § 23 (1997) (allowing an individual credit for qualified adoption expenses paid or incurred, up to $5000, or a credit of $6000 in the case of a child with special needs).

[46] *See* S. REP. NO. 104-288 (1996) (explaining that the purpose of the adoption tax credit is to help families defray adoption costs, and to promote the adoption of minority children); 142 CONG. REC. E787-02 (May 10, 1996) (statement of Rep. Stokes) (describing the adoption tax credit as an effort to facilitate the adoption of children, and to decrease the time that children spend in the foster care system); 142 CONG. REC. H4766-01, 4766 (May 9, 1996) (statement of Rep. Pryce) (emphasizing the goal of legislation to promote and encourage adoption); 142 CONG. REC. H4766-01, 4769 (May 9, 1996) (statement of Rep. Hall) (detailing legislative aim to place a greater number of children into loving families).

[47] *See* 26 U.S.C. § 51 (1997) (offering employers a credit against tax liability for hiring individuals from nine target groups who traditionally have had difficulty obtaining and holding jobs).

[48] *See Targeted Jobs Tax Credit: Testimony of Rep. Rush Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means*, 1994 WL 527376 (Sept. 29, 1994) (supporting the targeted jobs tax credit and recommending improvements to the program which aims to employ economically disadvantaged citizens).

income housing tax credit program,[49] with its goal of encouraging investment in low-rental housing,[50] the charitable contributions deduction,[51] which aims at encouraging contributions to appropriate causes,[52] and the "sin taxes,"[53] which have the goals of preventing unhealthy lifestyles and promoting consumer well-being.[54] Congress consistently uses the tax laws to accomplish objectives that are not tax related. Thus, if one is convinced that there is an important non-revenue related goal that can be achieved by affecting the deductions allowed for executive compensation, there is no reason not to use that tool.[55]

The first possible goal that could motivate Congress is a desire to affect the amount or type of compensation paid to executives. There is evidence to suggest that the Code provisions ad-

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[49] *See* 26 U.S.C. § 42 (1997) (allowing owners of qualified low-income buildings to claim housing credit allocations received from state or local housing credit agencies).

[50] *See id.*

[51] *See id.* § 170(b)(1)(A) (allowing deductions for charitable contributions including gifts to churches, educational organizations, or other private foundations).

[52] *See* RICHARD GOODE, THE INDIVIDUAL INCOME TAX 160-61 (1976) (arguing that the primary purpose of the charitable contributions deduction was to encourage charitable giving). The charitable contribution deduction appears to be quite effective in stimulating charitable giving. *See* Gerald A. Auten & Gabriel Rudney, *The Variability of the Charitable Giving by the Wealthy*, *in* PHILANTHROPIC GIVING: STUDIES IN VARIETIES AND GOALS 72, 79 (1989); Nina J. Crimm, *Tax Plans for the Twenty-First Century: Medical Incentive Vouchers Address the Needs of Academic Health Centers and the Elderly*, 71 TUL. L. REV. 653, 688 (stating that the charitable deduction appears to be quite as effective as "a stimulus for charitable giving"); Fred Stokeld, *Charities Fear Loss of Deduction under Flat Tax Proposals*, 70 TAX NOTES 935, 936 (1996) (citing figures from IRS Statistics of Income Division that individual income tax deductions for charitable contributions was approximately $100 billion).

[53] *See* 26 U.S.C. § 5001 (1997) (imposing on all distilled spirits produced in or imported into the United States a tax at the rate of $13.50 on each proof gallon and a proportionate tax on all fractions thereof); 26 U.S.C. § 5701 (1997) (imposing taxes on cigar, cigarette, and tobacco products based on relative weight or size).

[54] *See* Jendi B. Reiter, *Citizens or Sinners? The Economic and Political Inequity of "Sin Taxes" on Tobacco and Alcohol Products*, 29 COLUM. J.L. & SOC. PROBS. 443, 443 (1996).

[55] Indeed, the Code is already being used that way. Section 280G itself was not passed to address any abuses of the income tax laws, but to address compensation amounts that were viewed by Congress to be unreasonable. *See* DEFICIT REDUCTION ACT OF 1984, EXPLANATION OF PROVISIONS APPROVED BY THE SENATE COMM. ON MAR. 21, 1984 ON FINANCE, 98TH CONG., 2D SESS. 175, 195 (Comm. Print 1984); H.R. CONF. REP. NO. 98-861, at 757, 852 (1984), *reprinted in* 1984 U.S.C.C.A.N. 1445, 1540. Congress' purpose in enacting section 280G was also to discourage hostile acquisitions, another goal that is not tax-related. *See* GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, H.R. 98-4170, 98TH CONG., 2D SESS., at 174, 199-200 (Comm. Print 1984).

dressing executive compensation are motivated by this desire.[56]

As to whether the Code could become a more effective means of affecting the amount of executive compensation than it is today, the IRS could be encouraged to challenge deductions for executive compensation on the grounds that the amounts paid are unreasonable. The argument as to the feasibility of this approach is that while the courts "acknowledge that the issues are complex, that the exercise of judgment is necessary, and that the outcomes will lack precision,"[57] they do engage in the task of analyzing the reasonableness of compensation in the close corporation context.[58] In that context, courts have developed a list of factors to be used in deciding whether a deduction applies. These factors include the employee's qualifications and skill, the scope of her responsibilities, her role in the success of the business and a comparison of the compensation in question with the compensation of comparable individuals.[59] One can argue that these factors are no less relevant in the context of compensation paid to executives of publicly-held corporations.

There are, however, some difficulties with promoting this approach. Ironically, one of those problems is section 162(m), which was enacted in response to criticisms of the levels of executive compensation. To the extent that section is viewed as

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[56] *See supra* note 18 (suggesting Congressional concerns with the type of compensation) and note 32 and accompanying text (suggesting a concern with the amount of compensation); *see also* 141 CONG. REC. S11201-03 (Aug. 2, 1995) (statement of Rep. Boxer) (expressing concern with the amount of executive compensation when compared to that of employees); 140 CONG. REC. H8055-01 (Aug. 12, 1994) (agreeing to the imposition of limits on executive compensation within certain governmental departments); 138 CONG. REC. S14861-01 (Sept. 24, 1992) (illustrating Congressional concern with regard to the amount of compensation as compared to executive performance).

[57] Vagts, *supra* note 15, at 257.

[58] *See* Contract Reprod. Co. v. Commissioner, 54 T.C.M. (CCH) 600 (1987); Diverse Indus., Inc. v. Commissioner, T.C.M. (CCH) 525 (1986); Ray Clymer Jr. and Denison Poultry & Egg Co. v. Commissioner, 47 TCM (CCH) 1576 (1984); Demian, Ltd. v. Commissioner, 47 T.C.M. (CCH) 311 (1983).

[59] *See supra* note 58. One of the earliest cases to provide a comprehensive list of factors to be considered in making the reasonableness determination was *Mayson Manufacturing Co. v. Commissioner*, 178 F.2d 115 (6th Cir. 1949). *Mayson* established the factors to be used in the determination of reasonable compensation, including past compensation, the nature of the employee's work, and the difference between employee salaries and stockholder distributions. *See id.* at 119. For a detailed discussion of some of the more significant factors used by courts, see Charles A. Barragato, *Sustaining a Deduction for Reasonable Compensation*, 61 CPA J. 10 (1991).

defining reasonableness at the $1 million level, the addition of that section of the Code may make it difficult for courts to challenge compensation that is less than $1 million. That is unfortunate because, depending on the circumstances, $1 million may or may not be reasonable compensation for a particular executive. For some executives, it will be too little; for others, too much.

This leads to the second problem: it is virtually impossible for an external arbiter to evaluate compensation in absolute terms. If an amount of compensation paid is what is necessary to retain a highly prized executive who is being wooed by a competitor, in what sense can it be termed unreasonable? Five million dollars to keep a superstar CEO who has been responsible for turning an ailing company into a high performer and who is thinking of leaving the company in favor of a more lucrative position elsewhere is reasonable, whereas five million to an uninspired CEO of a sluggish company who has no other job prospects may be termed excessive. Moreover, an amount that may seem excessive standing alone may be reasonable given an executive's contribution to the corporation. Again, section 162(m) aggravates the situation. The exclusion for performance-based plans makes the adoption of such plans more desirable and the movement towards performance-based compensation makes judgments of reasonableness even more difficult.

> Imagine a complaint that a particular pay for performance plan provides too much incentive and too little risk—that is, executives get too much pay in both good times and bad times. A court would be charged with evaluating the board's judgment concerning the trade off between risk sharing and incentives. But because these are "local" decisions that not only lack a determinative conceptual framework, but depend on the peculiarities of particular companies and particular industries, it is difficult to imagine how a court bent on monitoring compensation decisions would proceed.[60]

To use the Code more effectively as a means of affecting executive compensation, alternatives to the reasonableness ap-

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[60] Ronald J. Gilson, *Executive Compensation and Corporate Governance: An Academic Perspective*, 792 PRAC. L. INST. 647, 672-73 (1992). Though Gilson is speaking in the context of the judicial application of corporate law standards, his comments apply equally to the difficulty of determining reasonableness for purposes of the Code.

proach do exist. One could replace the approach taken by section 162 of the Code by simply disallowing deductions which exceed a stated amount.[61]

The effectiveness of such limits is questionable. By definition, the Code approach holds only the threat of loss of deductibility of compensation. Therefore, these limits will not necessarily change behavior. As experience with section 280G has suggested, there will be many employers who will decide to pay whatever compensation they wish, notwithstanding the tax penalty, simply making compensation more expensive to the corporation.[62] In fact, that has been the experience with the limits imposed by section 162(m).[63]

Additionally, the use of Code limits will always involve one of two alternatives: an absolute limit on deductible compensation or an approach that excludes certain forms of compensation from the limit. The former approach suffers from rigidity. The latter, as the experience with section 162(m) suggests, renders the limit meaningless.

Regardless of the potential effectiveness of the Code as an increased constraint on the amount or type of compensation, it should not be so used. Compensation is a matter for the market and private parties and not one requiring government involvement. What corporations pay to their executives, and in what form compensation is paid, is clearly a business decision between the company and its owners, the shareholders. While the government is justified in assuring that shareholders are aware of what executives are paid[64] and that shareholders have the ability

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[61] Pensions are an example of such a limit where there is a limit on the amount of compensation that can be taken into account for purposes of calculating pension benefits. *See* 26 U.S.C. § 401(a)(17) (1997). Nothing in the statute or its legislative history suggests that pension benefits in excess of such amounts are not "reasonable."

[62] *See* Brownstein & Panner, *supra* note 4, at 34; Macey, *supra* note 35, at 12.

[63] *See supra* note 22.

[64] In 1992, the Securities Exchange Commission ("SEC") enacted major changes to its proxy and disclosure rules, which were designed to give American stockholders of publicly-held corporations a clearer picture of the compensation paid to the CEO and the other highest paid executive corporate officer. *See* Executive Compensation Disclosure, Exchange Act Release No. 34-31,327; Investment Company Act, 57 Fed. Reg. 48,126 (1992), *as corrected in* Executive Compensation Disclosure Correction, Exchange Act Release No. 31,420; Investment Company Act, 57 Fed. Reg. 53,985 (1992). This involved making changes to the executive compensation disclosure requirements contained in Regulation S-K, as well as changes to Schedule 14A and Form 10K. *See* Treas. Reg. §§ 229, 240.14a, 249.310 (1993).

to object if they are dissatisfied with compensation decisions made by a corporation's board of directors,[65] it should not substitute its own judgment on what is paid and how. Therefore, if the motivation of Congress in enacting Code provisions addressing executive compensation is to affect the amount or type of compensation paid to executives, the action is inappropriate.

While there is no societal concern (as opposed to concern of shareholders) implicated by attempting to regulate the amount and type of compensation, it is possible to articulate a social goal that focuses on the amount executives are paid in relative terms. The second possible goal that might motivate Congress to use the Code to police executive compensation is a social goal: the desire to affect the relationship between executive compensation and the pay of rank and file employees. Congress could decide that "[p]ublic policy does not support extreme distortions in income" between executives and lower level employees.[66]

If shortening the distance between the top and bottom of the pay scale is Congress' goal, the current Code does nothing to further that goal, since the current provisions focus solely on the amount and type of executive pay. It may be possible, however, to change the Code to promote this goal more effectively. For example, Representative Sabo has proposed limiting the tax deductibility of executive compensation to twenty-five times the compensation of the lowest paid full time worker in the same organization.[67] Unlike the current Code provisions, this approach

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[65] In 1992, the SEC also enacted new rules designed to ease substantially communications between shareholders, thus allowing them the ability to mobilize when unhappy about compensation decisions. *See* The Regulation of Communications Among Shareholders, 57 Fed. Reg. 48,276-01 (1992) (codified at Treas Reg. pts. 240, 249). At the same time, the SEC decided that the issue of executive compensation was an appropriate subject for a shareholder proxy proposal. *See* SEC News Release No. 92-12, *Statement of Richard C. Breedon on Executive Compensation Issues* (Feb. 13, 1992); *see also* Northern States Power Co., SEC No-Action Letter, 1994 WL 46873, at *2 (Dec. 23, 1993).

[66] Barris, *supra* note 23, at 79 (noting statement of Rep. Sabo). This is the view that leads to proposals like that of Rep. Sabo. *See infra* note 67 and accompanying text; *see also supra* note 9. Ralph Whitworth, executive director of United Shareholders Association, criticized the Sabo bill as "wrongheaded because it doesn't address the central issue, which is pay for performance. It's not how much [executives] get paid, it's how they get paid." Johnson, M., *supra* note 22, at 8.

[67] *See* The Income Disparities Act of 1991, H.R. 3056, 102d Cong. (1991) (disallowing a tax deduction for "excessive compensation," defined as an amount equal to 25 times the lowest compensation paid by the employer for the personal services of any other employee).

forces companies to examine the relationship between salaries of executives and rank and file employees.

This raises the question whether reforming disparity in pay is a goal Congress should be pursuing. I believe it is not and that the disparity in pay between executives and rank and file employees should not lead to government action. From an economic point of view, the disparity is irrelevant. The market for rank and file employees is simply different from the market for executives. A company will pay its rank and file employees what it perceives to be necessary to retain an adequately-sized and productive work force and there is no economic reason why it should consider executive compensation in determining what that necessary rank and file pay is. While Congress may have legitimate social concerns about wealth disparity,[68] it should find another way to address those concerns[69] that does not involve interfering with a company's business decision in setting the wages of its employees.

The final goal Congress could have is a revenue-raising one. Congress could simply decide that there is a limit on the largess of the federal government in this area. While raising revenue is always a legitimate use of the Code, it does not appear to be the goal which Congress is seeking to achieve. If that is to be the goal, then the executive compensation deduction needs to be evaluated in conjunction with other deductions or alternative means for increasing revenue, and not standing on its own.

[68] *See* EDWARD N. WOLFF, TOP HEAVY: A STUDY IN THE INCREASING INEQUALITY OF WEALTH IN AMERICA 5 (1995) (reporting increasing inequality in both income and wealth); PHILLIPS, *supra* note 40, at ix (analyzing the combined net worth of the four hundred richest Americans which trebled from $92 billion in 1982 to $270 billion in 1989, during the same time that U.S. median family income barely stayed ahead of inflation).

[69] *See* BOK, *supra* note 1, at 275-80. If Congress' primary concern is income disparity, it should consider a suggestion made by Derek Bok that would not affect business decisions. Bok suggests that "the ideal way to remove excessive earnings in a highly imperfect market" is a more steeply progressive income tax, arguing that such a proposal will require little or no administrative burden and that it will not risk driving talented people arbitrarily from one occupation to another. *Id.* Such a notion is not new. In 1963, an executive who earned taxable income of over $400,000 had a marginal tax rate of 91%. *See* CRYSTAL, *supra* note 15, at 25. In recent years, we have seen quite high tax rates. Individual income was taxed at a rate of 50% until 1987 and, as recently as 1968, the rate was 70%. *See id.* at 150.

CONCLUSION

What a corporation pays its executives and in what form is a business decision, appropriately determined by the board of directors of a company. As long as the ultimate owners of the company—its shareholders—are aware of what executives are being paid and have the ability to express displeasure if they do not like the decisions being made by the board, there is no place for government in the process. Notwithstanding concerns about the increasing inequalities of wealth between those at the top and at the bottom of the economic ladder, Congress should not attempt to regulate what a company pays its executives in relation to what it pays its rank and file employees.

While raising revenue is a legitimate use of the Code, raising tax revenues does not appear to be Congress' goal in enacting the provisions that currently limit the executive compensation deduction. Thus, Congressional motives need to be articulated prior to attempts of government regulation in this area. Absent defense of another goal, the Code has no role in policing executive compensation.