



Volume 17 (2019) | ISSN 1932-1821 (print) 1932-1996 (online)
DOI 10.5195/taxreview.2019.106 | <http://taxreview.law.pitt.edu>

NOTE

REINSTATING AND REVISING § 162(M)'S PERFORMANCE-BASED
PAY EXCEPTION

Charlie Buttgerit



This work is licensed under a Creative Commons Attribution-NonCommercial-No Derivative Works 3.0 United States License.



This journal is published by the [University Library System](#) of the [University of Pittsburgh](#) as part of its [D-Scribe Digital Publishing Program](#), and is cosponsored by the [University of Pittsburgh Press](#).

NOTE

REINSTATING AND REVISING § 162(M)'S PERFORMANCE-BASED PAY EXCEPTION

*Charlie Buttgereit**

I. INTRODUCTION

Section 162(m) of the Internal Revenue Code has been one of the most scrutinized tax provisions in recent history. This provision limits the deductibility of executive compensation paid by publicly held companies to top-level executives in excess of \$1 million per year.¹ Operating as a limit on § 162(a), which permits companies to deduct “a reasonable allowance for salaries or other compensation,”² § 162(m) was implemented in an attempt to prevent publicly held companies from deducting compensation paid to top-level executives that was deemed “excessive” (i.e., compensation that was not reasonable).³ Although well-intentioned, the original implementation of § 162(m) contained an exception that easily enabled publicly held companies to circumvent the deduction limitation through the use of performance-based compensation packages, which provided the basis for § 162(m)'s scrutiny.⁴

* Candidate for JD, May 2020, University of Pittsburgh School of Law. Charlie gives special thanks to Professor Anthony Infanti for helping him develop this topic, the *Pittsburgh Tax Review* student editors for their assistance in preparing this Note for publication, and his family and friends for their endless support while he continued his education.

¹ I.R.C. § 162(m)(1) (2017).

² *Id.* § 162(a)(1).

³ H.R. REP. NO. 103-111, at 646 (1993); STAFF OF JOINT COMM. ON TAXATION, JCX-39-06, PRESENT LAW AND BACKGROUND RELATING TO EXECUTIVE COMPENSATION 5 (Comm. Print 2006) (explaining that the rationale behind the provision focused on the “unlimited tax benefit” provided to executive compensation).

⁴ I.R.C. § 162(m)(4)(C) (2017).

These performance-based compensation packages generally consisted of equity awards (i.e., stock options, restricted stock, performance shares, etc.) that were used to incentivize executives to successfully run their businesses.⁵

However, Congress's enactment of the Tax Cuts and Jobs Act of 2017 (TCJA) made significant changes to § 162(m).⁶ Specifically, TCJA (1) broadened the types of companies subject to the limitation;⁷ (2) expanded the scope and definition of a "covered employee" (the employees subject to the provision);⁸ and (3) most notably, repealed the performance-based pay exception.⁹ While all three of these changes will likely force publicly held companies to reevaluate their current executive compensation structures, recent studies have suggested that publicly held companies will almost certainly continue to offer equity-based compensation packages to top-level executives.¹⁰ This is quite troubling considering equity-based compensation has likely influenced the dramatic increase in executive compensation over the past few decades,¹¹ which has subsequently contributed to the extraordinary pay gap between top-level executives and lower-level employees.¹² Equally troubling, when companies issue equity-based compensation awards, executives become highly incentivized to seek short-

⁵ *Basics of Executive Compensation*, CTR. ON EXECUTIVE COMPENSATION, <http://www.excecomp.org/Basics/Basic/Equity-Compensation> (last visited Dec. 8, 2019).

⁶ See Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13601, 131 Stat. 2054, 2155 (2017).

⁷ *Id.* § 13601(c), 131 Stat. at 2156.

⁸ *Id.* § 13601(b), 131 Stat. at 2156.

⁹ *Id.* § 13601(a), 131 Stat. at 2155.

¹⁰ Kobi Kastiel & Noam Noked, *The "Hidden" Tax Cost of Executive Compensation*, 70 STAN. L. REV. ONLINE 179, 184 (2018).

¹¹ See David I. Walker, *Expanding and Effectively Repealing the Executive Pay Deductibility Limitations*, 160 TAX NOTES 1819, 1822 (2018) ("Between 1993 and 2001, median pay for S&P 500 CEOs increased from \$3.1 million to \$10 million (in 2016 dollars), and the growth was almost entirely in the form of cash bonuses and equity compensation, principally stock options . . ." (citing Kevin J. Murphy & Michael C. Jensen, *The Politics of Pay: The Unintended Consequences of Regulating Executive Compensation* 58 (Univ. S. Cal. Ctr. for Law & Soc. Sci. Legal Studies Papers Series, Paper No. 18-8, 2018))).

¹² See LAWRENCE MISHEL & JESSICA SCHIEDER, ECON. POL'Y INST., CEO PAY REMAINS HIGH RELATIVE TO THE PAY OF TYPICAL WORKERS AND HIGH-WAGE EARNERS (2017), <https://www.epi.org/publication/ceo-pay-remains-high-relative-to-the-pay-of-typical-workers-and-high-wage-earners/>.

term growth in hopes of increasing their companies' stock prices, misaligning the interests of executives and corporate shareholders.¹³

Therefore, because many companies will likely continue to offer equity-based awards to top-level executives despite the inability to deduct compensation in excess of \$1 million (potentially enabling executives to earn more in the future), this Note advocates for reinstating a revised performance-based pay exception into § 162(m) to curtail executive compensation and more appropriately align the interests of executive management and corporate shareholders. These revisions would narrow the definition of performance-based compensation, limiting a publicly held company's ability to take deductions for traditional equity awards (i.e., stock options, stock appreciation rights, etc.), while providing deductions for performance-based pay that is truly indicative of an executive meeting a reasonable performance goal based on long-term growth.¹⁴

The theory behind this strategy supports the proposition that the legislative intent behind § 162(m) was sound—to encourage publicly held companies to offer top-level executives “reasonable” pay by aligning the interests of corporate shareholders and executive management.¹⁵ The original implementation of § 162(m) attempted to do this, but inadvertently caused a spike in executive pay due to the dramatic use of stock options.¹⁶ The removal of § 162(m)'s performance-based pay exception appears to have been intended to solve this problem.¹⁷ However, considering the Joint Committee

¹³ See Janice Kay McClendon, *Bringing the Bulls to Bear: Regulating Executive Compensation to Realign Management and Shareholders' Interests and Promote Corporate Long-Term Productivity*, 39 WAKE FOREST L. REV. 971, 994–1000 (2004).

¹⁴ This Note does not suggest that § 162(m) should be repealed entirely. Congress was likely justified in reducing the magnitude of the deduction to satisfy the “reasonableness” requirement set forth under § 162(a).

¹⁵ H.R. REP. NO. 103-111, at 646 (1993).

¹⁶ See Walker, *supra* note 11, at 1822 (citing Gregg D. Polsky, *Controlling Executive Compensation Through the Tax Code*, 64 WASH. & LEE L. REV. 877, 906 (2007)); see also Meredith R. Conway, *Money for Nothing and the Stocks for Free: Taxing Executive Compensation*, 17 CORNELL J.L. & PUB. POL'Y 383, 410 (2008).

¹⁷ H.R. REP. NO. 115-409, at 331 (2017) (“The Committee believes that the significant exceptions to the limit on deductible executive compensation . . . have resulted in a shift away from cash compensation paid to senior executives in favor of stock options and other forms of performance pay. The Committee further believes this shift has led to perverse consequences resulting from the focus of such

on Taxation's analysis of the federal budget in light of TCJA, it appears the removal of § 162(m)'s performance-based pay exception was likely a revenue-raising measure implemented to offset potentially lost tax revenue stemming from the reduced corporate income tax rate in 2018.¹⁸ For instance, it is estimated that TCJA's expansion of § 162(m) will generate roughly \$1 billion of revenue per year for the federal government.¹⁹

Moreover, the removal of the performance-based pay exception causes a major transparency issue considering (1) publicly held companies will no longer need to meet the stringent standards previously required to qualify for the exception, and (2) the "tax cost" associated with the exception's removal is likely too trivial to cause publicly held companies to alter their current executive pay practices. For example, in 2017, Starbucks generated \$4.3 billion in earnings; however, during this same year, Kobi Kastiel and Noam Noked observed that the repeal of § 162(m)'s performance-based exception would only cost Starbucks roughly \$8.7 million in tax on executive compensation.²⁰ To solve this problem, a revised performance-based pay exception should be reinstated into § 162(m) that rewards executives who achieve long-term business success. This would (1) incentivize corporations to restructure executive pay plans, (2) more closely align the interests of executive management and corporate shareholders, and (3) promote transparency regarding executive pay throughout the private sector.

The remainder of this Note is divided into five parts. Part II provides a brief history of § 162(m). Part III highlights TCJA's changes to § 162(m). Part IV provides an analytical look at the potential tax burdens (or lack of tax burdens) publicly held companies may face as a result of TCJA's changes. Part V proposes the reinstatement of a revised performance-based pay exception into § 162(m) to prevent executive compensation from getting any more out of hand. Part VI contains brief concluding remarks.

executives and businesses on quarterly results, rather than the long-term success of the company and its rank-and-file workers.").

¹⁸ See Kastiel & Noked, *supra* note 10, at 180.

¹⁹ STAFF OF JOINT COMM. ON TAXATION, 115TH CONG., MACROECONOMIC ANALYSIS OF THE CONFERENCE AGREEMENT FOR H.R. 1, THE "TAX CUTS AND JOBS ACT" 9 (Comm. Print 2018).

²⁰ Starbucks Corporation, Annual Report (Form 10-K), at 35 (Nov. 16, 2018); Kastiel & Noked, *supra* note 10, at 181.

II. BACKGROUND OF § 162(M)

A. Enactment of § 162(m)

Congress enacted § 162(m) as part of the Omnibus Budget Reconciliation Act of 1993.²¹ This provision capped the annual deduction a publicly held company could take for compensation paid to a covered employee (prior to TCJA, this included the company’s CEO and four other highest-paid employees) at \$1 million.²² Therefore, the maximum deduction a publicly held company could take annually for compensation paid to all of their covered employees (excluding performance-based compensation) was \$5 million (\$1 million for the CEO and \$1 million for each of the top four highest-paid executives). This legislation was fueled by massive public outcry regarding the “level and performance-insensitivity of executive pay” in America during the late 1980s and early 1990s.²³

As Meredith Conway has observed, throughout this time period Americans were justifiably concerned that executives were being significantly overpaid despite economic instability and poor overall corporate performance.²⁴ In 1992, these concerns turned into complaints after the American media highlighted the great disparity in executive pay between American and Japanese executives following one of the largest recessionary periods in U.S. history.²⁵ “Executive salaries at many corporations were continuing to rise every year by percentages in the double digits, while the value of the same corporations’ stock continued to drop.”²⁶ By 1995, the average CEO in America made roughly 122 times more than the average

²¹ Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13211, 107 Stat. 416, 469 (codified as amended at I.R.C. § 162(m)).

²² I.R.C. § 162(m)(3) (2017).

²³ Gregg D. Polsky, *Controlling Executive Compensation Through the Tax Code*, 64 WASH. & LEE L. REV. 877, 884 (2007); see Ryan Miske, Note, *Can’t Cap Corporate Greed: Unintended Consequences of Trying to Control Executive Compensation Through the Tax Code*, 88 MINN. L. REV. 1673, 1686 (2004) (noting that § 162(m) was enacted “after the populist outrage over executive compensation reached a high during the 1992 presidential race”).

²⁴ See Conway, *supra* note 16, at 396.

²⁵ *Id.*

²⁶ *Id.*

American employee.²⁷ However, in 1989, the average CEO in America made only fifty-nine times more than the average American employee, and in 1965 (roughly thirty years prior) the average CEO in America made a mere twenty times more than the average American employee.²⁸ Needless to say, the American public was not pleased and demanded a change.

Taking note of the public's overall dissatisfaction with the dramatic rise in executive pay throughout this time period (and likely to punch his ticket into the White House), presidential candidate Bill Clinton promised to rein in "excessive" executive pay once and for all.²⁹ As a result, in 1993, Congress enacted § 162(m) in an attempt to "link executive pay to the performance of the executive and the corporation."³⁰ "While this provision was sometimes justified by its proponents as denying a 'subsidy' for excessive executive pay, most proponents properly characterized it as a penalty for what they considered the illegitimate compensation practices of public companies."³¹

B. The Mechanics of § 162(m) and a Glimpse into Performance-Based Compensation

As previously noted, § 162(m) "capped a publicly held company's corporate income tax deduction at \$1 million per year for amounts paid to its chief executive and four highest paid employees," and applied only for as long as an individual remained a covered employee.³² While on its face this provision appeared warranted, § 162(m) provided a number of exceptions that easily enabled publicly held companies to circumvent the deduction limitation.³³ Specifically, "the deduction limit of § 162(m) applied to any compensation that could otherwise be deductible in a taxable year, *except for*

²⁷ ALYSSA DAVIS & LAWRENCE MISHEL, ECON. POL'Y INST., CEO PAY CONTINUES TO RISE AS TYPICAL WORKERS ARE PAID LESS (2014), <https://www.epi.org/publication/ceo-pay-continues-to-rise/>.

²⁸ *Id.*

²⁹ Conway, *supra* note 16, at 397.

³⁰ *Id.*

³¹ Polsky, *supra* note 23, at 884.

³² I.R.C. § 162(m)(1) (2017).

³³ See Treas. Reg. § 1.162-27 (as amended in 2015).

*enumerated types of payments set forth in § 162(m)(4).*³⁴ Therefore, in its original implementation, Congress did not limit the deductibility of all executive compensation; rather, “the limitation only applied to compensation not explicitly excluded, regardless of whether the compensation was for services as a covered employee and regardless of when the compensation was earned.”³⁵

Immediately after its enactment, many publicly held companies leveraged the exclusions set forth under § 162(m) and restructured their executive compensation packages in an attempt to avoid the limitation.³⁶ Companies quickly recognized that they could cap executive salaries at \$1 million and provide an alternative means of compensation that was specifically excluded to completely escape § 162(m)’s reach.³⁷ These alternative, excluded forms of compensation included: (1) compensation paid on a commission basis;³⁸ (2) compensation paid solely on account of the attainment of one or more performance goals (“performance-based compensation”);³⁹ (3) payments to a tax-qualified retirement plan;⁴⁰ (4) amounts that were excludable from the executive’s gross income (such as employer-provided health benefits and miscellaneous fringe benefits under § 132);⁴¹ and (5) any remuneration payable under a written binding contract which was in effect on February 17, 1993, and which was not modified in any material respect before such compensation was paid.⁴² Of these five types of excluded compensation, this Note will primarily analyze the effect of

³⁴ Disallowance of Deductions for Employee Remuneration in Excess of \$1,000,000, Prop. Treas. Reg. § 1.162-27, 1994-4 I.R.B. 24, 24 (emphasis added).

³⁵ STAFF OF JOINT COMM. ON TAXATION, *supra* note 3, at 3.

³⁶ See Conway, *supra* note 16, at 405–06.

³⁷ *Id.*

³⁸ Treas. Reg. § 1.162-27(d).

³⁹ *Id.* § 1.162-27(e)(2).

⁴⁰ *Id.* § 1.162-27(c)(3)(ii)(A).

⁴¹ *Id.* § 1.162-27(c)(3)(ii)(B).

⁴² *Id.* § 1.162-27(h)(1).

remuneration payable solely on account of the attainment of one or more performance goals (i.e., performance-based compensation).

The motivation behind the exclusions was to more closely tie executive pay to corporate performance; that is, to make executive compensation “more sensitive to firm performance.”⁴³ In other words, Congress allowed deductions for these excluded forms of compensation because they were believed to be indicative of an executive meeting performance goals that would ultimately benefit the companies and shareholders they worked for.⁴⁴ In doing so, Congress enabled publicly held companies to justify the significant amount of compensation they were paying their executives, so that, at least from the public’s perspective, the compensation seemed like it was being “earned” by the executives.

Upon § 162(m)’s enactment, the two primary forms of excluded compensation publicly held companies began awarding executives consisted of cash bonuses and performance-based compensation.⁴⁵ For instance, “[b]etween 1993 and 2001, median pay for S&P 500 CEOs increased from \$3.1 million to \$10 million (in 2016 dollars), and the growth was almost entirely in the form of cash bonuses and equity compensation, principally stock options, which alone accounted for more than half of the compensation of the median S&P 500 CEOs in 2001.”⁴⁶

Performance-based compensation generally consists of (1) compensation payable to a covered employee upon satisfaction of objective performance goals set by a committee composed of outside directors based on shareholder-approved goals⁴⁷ or (2) stock options or stock appreciation rights under a shareholder-approved plan.⁴⁸ “While not specifically mentioned in the legislative history, the exception to the

⁴³ Polsky, *supra* note 23, at 879.

⁴⁴ Conway, *supra* note 16, at 385–86.

⁴⁵ Walker, *supra* note 11, at 1822.

⁴⁶ *Id.* (citing Kevin J. Murphy & Michael C. Jensen, *The Politics of Pay: The Unintended Consequences of Regulating Executive Compensation* 58 (Univ. S. Cal. Ctr. for Law & Soc. Sci. Legal Studies Papers Series, Paper No. 18-8, 2018)).

⁴⁷ I.R.C. § 162(m)(4)(C) (2017).

⁴⁸ Treas. Reg. § 1.162-27(e)(2)(iii)(C), (e)(4) (as amended in 2015).

limitation for performance-based compensation reflect[ed] the view that such compensation, by its nature, is not ‘excessive.’”⁴⁹ To support this view, Congress created a number of criteria that needed to be met for the performance-based compensation to qualify for the exception.⁵⁰

Specifically, compensation qualified for the exception for performance-based compensation only if (1) it was “paid solely on account of the attainment of one or more preestablished, objective performance goals;”⁵¹ (2) the performance goals were established by a compensation committee consisting solely of two or more outsiders;⁵² (3) the material terms under which the compensation was to be paid, including the performance goals, were disclosed to and approved by the shareholders in a separate vote prior to payment;⁵³ and (4) prior to payment, the compensation committee certified that the performance goals and any other material terms were in fact satisfied.⁵⁴

Additionally, “[c]ompensation (other than stock options or other stock appreciation rights) [was] not treated as paid solely on account of the attainment of one or more performance goals unless the compensation [was] paid to a particular executive pursuant to a preestablished objective performance formula or standard that preclud[ed] discretion.”⁵⁵ These performance formulas typically included increases in (1) stock price, (2) market share, (3) sales, (4) earnings per share (EPS), (5) return on equity, or (6) costs.⁵⁶ However, stock options or other stock appreciation rights did not need to meet this standard and were generally “treated as meeting the exception for performance-based compensation, provided that the requirements for outside director and shareholder approval were met . . .

⁴⁹ H.R. REP. NO. 103-111, at 646 (1993); STAFF OF JOINT COMM. ON TAXATION, *supra* note 3, at 6.

⁵⁰ See Treas. Reg. § 1.162-27(e).

⁵¹ I.R.C. § 162(m)(4)(C); Treas. Reg. § 1.162-27(e)(2)(i).

⁵² I.R.C. § 162(m)(4)(C)(i); Treas. Reg. § 1.162-27(e)(3)(i).

⁵³ I.R.C. § 162(m)(4)(C)(ii); Treas. Reg. § 1.162-27(e)(4).

⁵⁴ I.R.C. § 162(m)(4)(C)(iii); Treas. Reg. § 1.162-27(e)(5).

⁵⁵ STAFF OF JOINT COMM. ON TAXATION, *supra* note 3, at 4.

⁵⁶ Treas. Reg. § 1.162-27(e)(2)(i).

because the amount of compensation attributable to the options or other rights received by the executive would be based solely on an increase in the corporation's stock price."⁵⁷ Stock-based compensation would not qualify for the exception if the exercise price of the option or base amount of the stock appreciation right was less than the fair market value of the stock on the date of grant or award (i.e., stock options and stock appreciation rights that were considered "in the money").⁵⁸

Stock-based compensation also was not treated as performance-based if it was dependent on factors other than corporate performance.⁵⁹ Likewise, compensation did not qualify for the performance-based exception if the facts and circumstances indicated that the executive would have received the compensation regardless of whether the performance goal was attained.⁶⁰ Under either of these circumstances, the options would be included in the \$1 million cap once they were exercised.⁶¹

It is important to note that, "[b]ecause 'performance-based' and 'equity-based' compensation are not synonymous, section 162(m) did not mandate equity-based compensation to avoid the \$1 million limitation."⁶² As Janice McClendon has observed, "corporations [could] avoid the section 162(m) limitation by linking cash salaries and bonuses above the \$1 million benchmark to corporate performance" metrics.⁶³ However, because equity-based compensation is directly linked to market performance and stock price, publicly held companies were incentivized by § 162(m) to utilize equity-based compensation structures to satisfy the requirements of § 162(m) from an administrative standpoint.⁶⁴

⁵⁷ STAFF OF JOINT COMM. ON TAXATION, *supra* note 3, at 4–5.

⁵⁸ Treas. Reg. § 1.162-27(e)(2)(vi)(A) (effective for grants on or after June 24, 2011); Anne Moran, *Reasonable Compensation*, 390 TAX MGMT. PORTFOLIO (BNA) § X(D) (2018).

⁵⁹ Moran, *supra* note 58, § X(D).

⁶⁰ Treas. Reg. § 1.162-27(e)(2)(iii)(v).

⁶¹ *Id.* § 1.162-27(e)(2)(vi).

⁶² McClendon, *supra* note 13, at 979.

⁶³ *Id.*

⁶⁴ *Id.* at 979–80.

C. Section 162(m)'s Bark Has Been Louder Than Its Bite

Looking back, § 162(m) fulfilled a campaign promise, but in reality, its bark was much louder than its bite. Senator Charles E. Grassley (R-Iowa) commented, “[r]egardless of how you feel about limiting compensation through the tax code, the current law is like a gnat on an elephant in accomplishing its goal. It’s easy to swat away, and that’s exactly what many companies do.”⁶⁵ Senator Grassley’s comments still ring true today. Since its enactment, most publicly held companies have either (1) found a way around § 162(m)’s limitations through the use of the performance-based compensation exception or (2) disregarded it altogether, determining that it was in the company’s best interest to pay executives in excess of the limitation.⁶⁶ Some commentators have noted, “Section 162(m) did not constrain the levels of senior executive pay—in fact, the rule likely sparked increasing pay levels—but it is generally believed that section 162(m) contributed to the dramatic increase in the use of stock options and other forms of performance-based pay in the 1990’s.”⁶⁷

Today, CEO pay continues to pose an income inequality issue, as it is “increasing at almost twice the rate of ordinary wages.”⁶⁸ The Economic Policy Institute recently reported that the average CEO now makes roughly 278 times more than the average worker, with stock options comprising a major portion of their compensation.⁶⁹ Additionally, recent studies have suggested that despite Congress’s effort to curtail executive compensation, publicly held companies will almost certainly continue to offer performance-

⁶⁵ Cydney Posner, *Is Section 162(m) Just “A Gnat on an Elephant”?*, COOLEY PUB. CO. (Feb. 18, 2016), <https://cooleypubco.com/2016/02/18/is-section-162m-just-a-gnat-on-an-elephant/>.

⁶⁶ Conway, *supra* note 16, at 405–06 (“Many corporations decided that the limitations interfered with their ability to set what they deemed to be the appropriate level of compensation and, as a result, decided that it was in the best long-term interests of the corporation to forgo the deduction.”).

⁶⁷ Walker, *supra* note 11, at 1822 (citing Gregg D. Polsky, *Controlling Executive Compensation Through the Tax Code*, 64 WASH. & LEE L. REV. 877, 906 (2007)).

⁶⁸ Peter Eavis, *It’s Never Been Easier to Be a C.E.O., and the Pay Keeps Rising*, N.Y. TIMES (May 24, 2019), <https://www.nytimes.com/2019/05/24/business/highest-paid-ceos-2018.html> (“In 2018, the median [CEO] received compensation of \$18.6 million—a raise of \$1.1 million, or 6.3 percent, from the prior year.”).

⁶⁹ LAWRENCE MISHEL & JULIA WOLFE, ECON. POL’Y INST., CEO COMPENSATION HAS GROWN 940% SINCE 1978 (2019), <https://www.epi.org/publication/ceo-compensation-2018/>.

based compensation packages to their top-level executives.⁷⁰ One of the reasons is that the lost tax deduction is simply trivial considering the amount of revenue the majority of the companies affected by the provision make.⁷¹ Additionally, in many cases the now-reduced corporate income tax rate will offset the impact of the lost deduction, and performance-based pay packages are generally viewed as necessary to keep and attract top talent.⁷² Partners at the law firm Wachtell, Lipton, Rosen & Katz have stated that “[the changes to § 162(m)] will result in a significant increase in disallowed tax deductions. Nevertheless, we expect that companies will accept this result as a necessary consequence of the competitive marketplace for talent.”⁷³ Therefore, although well-intentioned, § 162(m) has not lived up to the hype. The original implementation of § 162(m) fueled a dramatic rise in executive pay, and without any incentive for publicly held companies to alter their current pay structures, executive pay will almost certainly reach new heights in the future. Further troubling, because all performance-based pay in excess of the \$1 million limitation is now nondeductible, companies may become less transparent regarding executive pay, leaving shareholders uninformed and potentially burdened by the added tax cost of amended § 162(m).⁷⁴

III. MAJOR TCJA CHANGES TO § 162(M)

TCJA made significant changes to § 162(m). Specifically, TCJA: (1) broadened the types of companies subject to the limitation,⁷⁵

⁷⁰ See, e.g., Kastiel & Noked, *supra* note 10, at 184.

⁷¹ See DEP’T OF TREASURY, REVENUE CONSEQUENCES OF 162(m), at 1 (2016), <https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/Firms-Exceeding-162m.pdf> (noting that even prior to the enactment of the TCJA, “members of compensation committees for four of the nation’s largest corporations said that 162(m) is merely a nuisance that has not stopped them from paying executives whatever they consider fair” (citing Keith Epstein & Eamon Javers, *How Bill Clinton Helped Boost CEO Pay*, BLOOMBERG (Nov. 27, 2006, 12:00 AM), <https://www.bloomberg.com/news/articles/2006-11-26/how-bill-clinton-helped-boost-ceo-pay>)).

⁷² See Kastiel & Noked, *supra* note 10, at 183–84.

⁷³ Jeannemarie O’Brien et al., *Compensation Season 2018*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 9, 2018), <http://perma.cc/CX5K-YM5X> (quoted in Kastiel & Noked, *supra* note 10, at 183).

⁷⁴ See Kastiel & Noked, *supra* note 10, at 179–80.

⁷⁵ Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13601(c), 131 Stat. 2054, 2156 (2017).

(2) expanded the scope and definition of a “covered employee,”⁷⁶ and (3) repealed the performance-based compensation exemption.⁷⁷ This section discusses these changes in greater detail.

A. Publicly Held Companies

Prior to 2018, § 162(m) applied only to publicly held companies that issued common equity securities required to be registered under section 12 of the Exchange Act.⁷⁸ TCJA broadened the scope of this definition by including additional classes of companies subject to the provision.⁷⁹ Section 162(m)(2) now provides that a publicly held company includes “any corporation which is an issuer . . . (A) the securities of which are required to be registered under section 12 of such Act, or (B) *that is required to file reports under section 15(d) of such Act.*”⁸⁰ Considering this change, foreign corporations with equity traded through American depository receipts (ADRs) and domestic corporations with publicly traded debt are now also subject to § 162(m).⁸¹ The new definition also applies to certain companies that do not have publicly traded securities but that are nonetheless subject to certain reporting requirements.⁸² Therefore, some privately held corporations will be less incentivized to remain off the public exchanges, some privately held corporations will be incentivized to redeem their publicly traded debt, and some foreign corporations will be incentivized to buy back their existing ADRs.⁸³

⁷⁶ *Id.* § 13601(b), 131 Stat. at 2156.

⁷⁷ *Id.* § 13601(a), 131 Stat. at 2155.

⁷⁸ Treas. Reg. § 1.162-27(c)(1)(i) (as amended in 2015).

⁷⁹ See Steven Balsam et al., *How the 2017 Tax Overhaul Changed Sec. 162(m)*, TAX ADVISOR (June 1, 2018), https://www.thetaxadviser.com/issues/2018/jun/how-2017-tax-overhaul-changed-sec-162m.html#fnref_3 (providing a more thorough analysis of all the additional classes of companies subject to the provision).

⁸⁰ I.R.C. § 162(m)(2) (emphasis added).

⁸¹ Balsam et al., *supra* note 79.

⁸² *Id.*

⁸³ *Id.*

B. Covered Employees

TCJA also modified the definition of a covered employee (i.e., the employees subject to the \$1 million limitation) by mandating the inclusion of a publicly held company’s chief financial officer and by creating the “eternal covered employee.”⁸⁴ Prior to 2018, covered employees were defined as (1) the chief executive officer and (2) any employee whose total compensation was required to be reported for the taxable year under the Securities and Exchange Act of 1934 because the employee was one of the four highest compensated officers for the taxable year, other than the chief executive officer.⁸⁵ Additionally, “if disclosure [was] required with respect to fewer than four executives (other than the chief executive officer) under the SEC rules, then only those for whom disclosure [was] required [were] covered employees.”⁸⁶

Under TCJA, a covered employee is now defined as: (1) “the principal executive officer *or principal financial officer* of the taxpayer at any time during the taxable year, or . . . an individual acting in such a capacity,”⁸⁷ (2) employees whose total compensation for the taxable year is “required to be reported to shareholders under the Securities and Exchange Act of 1934” because the employee was “among the 3 highest compensated officers for the taxable year” (other than the chief executive officer or chief financial officer),⁸⁸ and (3) any employee who “was a covered employee of the taxpayer (or any predecessor) for any preceding taxable year beginning after December 31, 2016.”⁸⁹ Therefore, TCJA now mandates the inclusion of a corporation’s (1) chief executive officer, (2) chief financial officer, (3) three highest compensated employees other than the chief executive officer and chief financial officer, and (4) any employee who was previously classified as a covered employee.

⁸⁴ Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13601(b)(1), (3), 131 Stat. 2054, 2156 (2017).

⁸⁵ I.R.C. § 162(m)(3)(A), (B) (2017).

⁸⁶ STAFF OF JOINT COMM. ON TAXATION, *supra* note 3, at 3.

⁸⁷ I.R.C. § 162(m)(3)(A) (emphasis added).

⁸⁸ *Id.* § 162(m)(3)(B).

⁸⁹ *Id.* § 162(m)(3)(C).

From a purely tax perspective, the modification to include a publicly held company's chief financial officer and three other highest paid employees (other than the chief executive officer) appears rather insignificant. However, TCJA's creation of the "eternal covered employee" might impact a publicly held company's decision to alter its executive management structure. The "eternal covered employee" provision essentially mandates that once an employee is classified as a covered employee, they will always be a covered employee. Therefore, if a publicly held company awards an employee a compensation package that would cause the employee to displace one of the currently three-highest paid executives, not only would that employee be subject to the \$1 million deduction limitation, but so would the executive that was removed from the group of the highest-paid employees.⁹⁰

C. Repeal of the Performance-Based Compensation Exception

TCJA's most notable change to § 162(m) was the repeal of the performance-based compensation exception.⁹¹ Prior to 2018, the \$1 million deduction limitation did not apply to qualified performance-based compensation, such as stock options and equity-based awards.⁹² However, under TCJA, any compensation earned by a covered employee in excess of \$1 million—including performance-based compensation—will no longer be deductible. This lost deduction (1) will directly increase the amount of income publicly held companies will be subject to tax on and (2) may cause transparency issues considering the stringent standards that no longer need to be met in order to qualify for the exception. Recall that, for performance-based compensation to qualify for the now-repealed exception, (1) a publicly held company needed to establish a compensation committee of two or more outside directors;⁹³ (2) the committee had to establish a plan using metrics

⁹⁰ Once an individual is on the covered employee list, he or she forever remains a covered employee, even after termination of employment or death. *See id.* § 162(m)(4)(F) ("Remuneration shall not fail to be applicable employee remuneration merely because it is includible in the income of, or paid to, a person other than the covered employee, including after the death of the covered employee.").

⁹¹ Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13601(a), 131 Stat. 2054, 2155 (2017).

⁹² Treas. Reg. § 1.162-27(e) (as amended in 2015).

⁹³ *Id.* § 1.162-27(e)(3)(i).

that tied the compensation to performance;⁹⁴ (3) shareholders were required to vote on the plan prior to any payouts;⁹⁵ (4) the compensation committee had to establish performance goals based on criteria that had been approved by the shareholders within ninety days and the goals had to be objective, with a substantially uncertain outcome;⁹⁶ and (5) the compensation committee had to certify that the performance goals were met before any payments were made.⁹⁷ These were relatively stringent requirements from a purely administrative standpoint that also gave shareholders some discretion in the executive pay process.

Under amended § 162(m), there is less incentive for publicly held companies to be transparent regarding executive compensation.⁹⁸ Regardless of the procedures followed and goals obtained, any compensation over \$1 million will be nondeductible if paid to a covered employee. “Corporations are still accountable to shareholders through both their performance and detailed proxy statement compensation disclosures. However, the repeal of the tax deduction will likely lead some corporations to adjust their compensation procedures to reduce their administrative expenses and increase board flexibility, which may influence their compensation arrangements.”⁹⁹ David Kokell, head of U.S. Compensation Research at Institutional Shareholder Services (ISS), expressed the concerns of many investors, stating that they fear that TCJA “encourages companies to be less transparent, less objective, less performance-based, and less well-governed around executive compensation than they are today—potentially rolling back

⁹⁴ *Id.* § 1.162-27(e)(2)(i).

⁹⁵ *Id.* § 1.162-27(e)(4).

⁹⁶ *Id.* § 1.162-27(e)(2)(i) (“A performance goal is objective if a third-party having knowledge of the relevant facts could determine whether the goal is met A performance goal need not, however, be based upon an increase or positive result under a business criterion and could include, for example, maintaining the status quo or limiting economic losses.”).

⁹⁷ *Id.* § 1.162-27(e)(5).

⁹⁸ See Kastiel & Noked, *supra* note 10, at 185–86 (finding that a hand-collected dataset of relevant proxy statements that were filed in the first fifty days after the enactment of the tax reform revealed that companies do not provide their shareholders with sufficient information about the tax cost of executive compensation).

⁹⁹ Balsam et al., *supra* note 79.

significant advances in executive compensation practices gained since the inception of broad say-on-pay in 2011.”¹⁰⁰

D. Transition Rules

TCJA did provide a transition rule outlining situations in which the current changes to § 162(m) do not apply.¹⁰¹ Specifically, TCJA provides that compensation under written binding contracts in effect as of November 2, 2017, will not fail to qualify for the previous exception so long as the contracts are not materially modified thereafter.¹⁰² This is referred to as the “grandfather rule.”¹⁰³ Therefore, companies are allowed to deduct “compensation (1) under existing performance-based arrangements [i.e., those in effect on November 2, 2017, including existing stock options and other performance-based equity awards], (2) for amounts earned and deferred under deferred compensation arrangements as of November 2, 2017, and (3) under arrangements in effect on November 2, 2017 with [chief financial officers] and any individual who would be covered by § 162(m) solely by virtue of that individual’s permanent ‘covered employee’ status.”¹⁰⁴

A contract in effect as of November 2, 2017, is a written binding contract only to the extent that the company is obligated under applicable law to pay the employee under the contract.¹⁰⁵ Additionally, even if there is a written binding contract protected under the grandfather rule, the amendments to § 162(m) will apply to any amounts that exceed the remuneration that applicable law obligates the company to pay pursuant to

¹⁰⁰ David Kokell et al., *U.S. Tax Reform: Changes to 162(m) and Implications for Investors*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 25, 2018), <https://www.issgovernance.com/library/u-s-tax-reform-changes-to-162m-and-implications-for-investors/>.

¹⁰¹ Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13601(e)(2), 131 Stat. 2054, 2156 (2017).

¹⁰² *Id.*

¹⁰³ See I.R.S. Notice 2018-68, 2018-36 I.R.B. 418, 419.

¹⁰⁴ O’Brien et al., *supra* note 73; *see id.* (noting that the statutory language and the limited commentary in the conference agreement leave open questions as to how the transition rule may apply to certain contracts and specific circumstances); *see also* I.R.S. Notice 2018-68, 2018-36 I.R.B. 418, 419.

¹⁰⁵ I.R.S. Notice 2018-68, 2018-36 I.R.B. 418, 421.

the written binding contract.¹⁰⁶ Further, “the Act’s amendments to § 162(m) apply to a written binding contract that is renewed after November 2, 2017.”¹⁰⁷ “A written binding contract that is terminable or cancelable by the corporation without the employee’s consent after November 2, 2017 is treated as renewed as of the date that any such termination or cancellation, if made, would be effective.”¹⁰⁸ Thus, if the terms of the contract provide that it will be automatically renewed as of a certain date unless either the corporation or the employee provides notice of termination of the contract, the contract is treated as renewed as of the date that termination would be effective if notice were given, and any remuneration paid after the date of renewal is subject to amended § 162(m).¹⁰⁹ These transition rules, coupled with the three major changes noted above, will likely cause many publicly held companies to reevaluate their current executive compensation practices going forward; however, as discussed in Part IV, many speculate that these changes will not be “burdensome enough” to result in any material alteration of executive compensation practices.

IV. AN ANALYTICAL OVERVIEW OF THE IMPACT OF § 162(M)

Considering the TCJA’s changes to § 162(m), many companies will likely see previously deductible executive compensation (e.g., performance-based compensation) trickle down into “taxable income,” ultimately increasing the amount of income a company will be subject to tax on.¹¹⁰ However, despite the fact that § 162(m) now requires companies to include more executive compensation on their tax returns, this impact will likely fail to discourage companies from offering performance-based compensation

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ See I.R.S. Pub. No. 525, Taxable and Nontaxable Income (2018). Generally, an amount included in your income is taxable unless it is specifically exempted by law. Income that is taxable must be reported on your return and is subject to tax. Income that is nontaxable may have to be shown on your tax return but is not taxable.

packages to their executive management teams.¹¹¹ First, the reduction in corporate income tax rates in 2018 may offset any increased tax burden from the lost deduction.¹¹² Second, the potential tax liability stemming from the newly taxable executive compensation will likely be minimal considering the amount of revenue many publicly held companies generate.¹¹³ Finally, even assuming there is a significant tax burden from the removal of the exception, companies may find it necessary to continue to pay executives substantial amounts in equity-based compensation to keep and attract top talent.¹¹⁴

A. Reduced Rates Will Likely Offset Amended § 162(m)'s Burdens

TCJA reduced the U.S. federal corporate income tax rate from thirty-five to twenty-one percent.¹¹⁵ Therefore, even though a company may be entitled to take fewer deductions during future taxable years (thus increasing taxable income), these companies will also be taxed at a lower rate on that income, potentially reducing or offsetting the effect of the lost deduction. This can be illustrated through a simple example. For instance, assume Company *A* reports gross income of \$30 million in both 2017 and 2018 (\$60 million over the two years). Further assume that in 2017, Company *A* was entitled to \$10 million in deductions related to salary under § 162(m)'s performance-based exception, and that in 2018, Company *A* was only entitled to \$5 million in deductions resulting from the removal of that exception (i.e., \$1 million for each covered employee). Using these figures, Company *A*'s taxable income in 2017 would be \$20 million (\$30 million – \$10 million), and in 2018 it would be \$25 million (\$30 million – \$5 million). However, although Company *A* reported more taxable income in 2018 due to its inability to deduct as much of its salary expenses as in 2017, Company *A*

¹¹¹ Madison Alder, *Tax Change Aside, Companies Stick with Executive Performance Pay*, BLOOMBERG (Oct. 9, 2018, 2:36 PM), https://www.bloomberglaw.com/document/XD716830000000?bna_news_filter=employee-benefits&jcsearch=BNA%2520000001663150deb9affeb578e6460000#jcite.

¹¹² Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13001, 131 Stat. 2054, 2096 (2017) (reducing the corporate income tax rate from thirty-five percent to twenty-one percent for taxable years beginning after December 31, 2017).

¹¹³ Walmart Inc., Proxy Statement (Form 14A), at 41 (Apr. 20, 2018) (Walmart reported over \$500 billion in revenue).

¹¹⁴ See Eugene Kandel, *In Search of Reasonable Executive Compensation*, 55 CESIFO ECON. STUD. 405, 412 (2009); see also Walker, *supra* note 11, at 1821.

¹¹⁵ Tax Cuts and Jobs Act § 13001, 131 Stat. at 2096.

would pay less in tax in 2018 because the reduction in the corporate tax rate offsets the increase in taxable income due to the lost deductions. If we compare the actual corporate income tax rates in 2017 and 2018, this is exactly what happens in this example. Using the new twenty-one percent corporate income tax rate, Company *A* would pay only \$5.25 million (\$25 million x 21%) in tax in 2018 compared to the \$7 million (\$20 million x 35%) in tax it was required to pay in 2017. The table below provides an illustration of this calculation.

	2017	2018
Gross Income	30,000,000	30,000,000
Deductions	10,000,000	5,000,000
Taxable Income	20,000,000	25,000,000
Tax Rate	35%	21%
Tax Liability	7,000,000	5,250,000

Therefore, even though many publicly held companies will likely see a reduction in deductible executive compensation, the reduction in the corporate income tax rate may more than offset any increased tax burden that would have resulted from losing the deduction. Where the reduced corporate income tax rate offsets the lost deduction, publicly held companies will not be incentivized to restructure their current executive compensation packages by the changes made to § 162(m).

B. The Tax Impact Is Trivial for the Majority of Publicly Held Corporations

In addition to the reduction in the corporate income tax rate, the potential tax burden resulting from TCJA's changes to § 162(m) might simply be too minuscule to deter companies from changing their executive compensation practices. Consider Walmart, which for six straight years has sat atop the Fortune 500 rankings in terms of revenue generated.¹¹⁶ In 2018,

¹¹⁶ Kevin McCoy, *Big Winners on "Fortune 500" List: Walmart; Exxon Mobil; Amazon*, USA TODAY (May 21, 2018, 10:58 AM), <https://www.usatoday.com/story/money/2018/05/21/big-winners-fortune-500-list-walmart-exxon-mobil-amazon/628003002/>.

Walmart generated revenue of \$500.3 billion and paid its named executive officers roughly \$63.8 million.¹¹⁷ Below is a table showcasing the compensation of Walmart's named executive officers in 2018.

Compensation of Named Executive Officers					
Walmart	Salary	Stock Awards	Incentive Plan Compensation	All Other Compensation	Total
Executive 1	1,276,982	15,692,464	4,736,750	473,765	22,179,961
Executive 2	871,087	4,237,993	2,027,759	316,133	7,452,972
Executive 3	1,051,426	6,857,031	2,921,173	178,168	11,007,798
Executive 4	780,827	9,856,525	1,665,728	538,384	12,841,464
Executive 5	1,030,770	6,316,436	2,792,895	123,384	10,263,485
Total	5,011,092	42,960,449	14,144,305	1,629,834	63,745,680
Deduction Prior to TCJA		62,104,754			
Deduction Per TCJA		5,000,000			
Difference		57,104,754			

* Data was obtained from Walmart's 2018 Proxy Statements

As can be seen from the data above, of Walmart's nearly \$63.7 million in compensation paid to covered employees, roughly \$5 million was in the form of fixed salaries, \$42.9 million was in the form of stock awards, \$14.1 million was in the form of incentive plan compensation, and the remaining \$1.6 million was lumped under "all other compensation."¹¹⁸ Walmart describes compensation in the "all other compensation" category as "tax gross-up payments paid during the year relating to imputed income attributable to spousal travel expenses, meals, and related activities in connection with certain Board meetings."¹¹⁹ Payments of these types were not covered under any of the exceptions in pre-TCJA § 162(m) and would therefore be considered nondeductible to the extent they exceeded the \$1 million threshold after factoring in the covered employee's fixed salary.

Considering this data, prior to TCJA, Walmart would have been entitled to a deduction of roughly \$62.1 million relating to executive compensation

¹¹⁷ See, e.g., Walmart Inc., Annual Report (Form 10-K), at 33 (Mar. 30, 2018); see also Walmart Inc., Proxy Statement (Form 14A), at 41 (Apr. 20, 2018).

¹¹⁸ See, e.g., Walmart Inc., Proxy Statement (Form 14A), at 41 (Apr. 20, 2018).

¹¹⁹ *Id.* at 37.

in 2018 had the performance-based pay exception not been repealed, or nearly all of the compensation paid to its covered employees. The \$42.9 million in stock awards and \$14.1 million in incentive plan compensation would have been entirely deductible.¹²⁰ Additionally, Walmart would have been entitled to deduct up to \$1 million of its covered employees' fixed salaries and "all other compensation."

However, under TCJA, Walmart will no longer be able to claim a deduction for the performance-based awards issued to its covered employees. Therefore, Walmart will be required to include all compensation in excess of \$1 million per covered employee in taxable income (roughly \$58 million). Using the new twenty-one percent corporate income tax rate, this would yield a tax liability of roughly \$12.2 million on Walmart's income that is no longer sheltered by the deduction for executive compensation (\$58 million x 21% = \$12.2 million). While \$12.2 million is a significant sum, considering Walmart generates more than \$500 billion in revenue, this tax liability likely falls short of being considered a burden.

As previously noted, Kobi Kastiel and Noam Noked have considered this "tax cost" of amended § 162(m) and demonstrated the unlikelihood that publicly held companies will alter their executive compensation practices as a result of TCJA's changes to § 162(m).¹²¹ In their essay, Kastiel and Noked calculated the potential tax burden amended § 162(m) would have on Starbucks, and ultimately determined that Starbucks would be required to pay \$8,673,918 in tax on their executive compensation in 2018 compared to \$154,808 in 2017 (the "tax cost" is about 266 times the cost under pre-TCJA § 162(m)).¹²²

From a purely mathematical perspective, the increased "tax cost" of amended § 162(m) seems rather alarming. However, considering Starbucks reported earnings before income taxes of \$4.3 billion in 2018,¹²³ an \$8.7 million increase in tax due to executive compensation practices once again appears rather insignificant. As Kastiel and Noked point out, it is unlikely

¹²⁰ See I.R.C. § 162(m)(4)(C) (2017).

¹²¹ Kastiel & Noked, *supra* note 10, at 182–85.

¹²² *Id.*

¹²³ See, e.g., Starbucks Corporation, Annual Report (Form 10-K), at 35 (Nov. 16, 2018).

that the changes to § 162(m) will force companies to voluntarily reduce their executive compensation levels despite the increased “tax cost.”¹²⁴

C. *The Need to Attract and Retain Effective Managers*

Considering how minuscule the impact of amended § 162(m) might be for publicly held companies, it is highly unlikely that we will see a shift away from equity-based pay in the future. However, even assuming there was a significant impact from a tax standpoint, an argument could still be made that boards must provide competitive pay packages to attract and retain effective managers.¹²⁵ The simple fact is that if companies do not offer performance-based awards to executives—enabling these executives to achieve significant levels of compensation—executives would likely flee to companies that would pay such amounts (perhaps a company that is not publicly held and therefore not subject to § 162(m)).¹²⁶ Therefore, even if amended § 162(m) did significantly increase a company’s tax liability, companies would almost certainly continue to offer equity-based pay packages to stay competitive in the market.

V. PROPOSAL

To encourage executive accountability and corporate transparency, Congress should reinstate a revised performance-based pay exception in § 162(m) that more closely ties executive pay to actual performance. As noted by many scholars, “TCJA’s expansion of § 162(m) is essentially the equivalent of an entire repeal of the provision” in terms of the likely impact on the level of compensation executives will be awarded by their respective companies.¹²⁷ Yet, TCJA’s expansion of § 162(m) does reduce the level of

¹²⁴ Kastiel & Noked, *supra* note 10, at 179.

¹²⁵ Joy Sabino Mullane, *The Unlearning Curve: Tax-Based Congressional Regulation of Executive Compensation*, 60 CATH. U. L. REV. 1045, 1077 (2011); *see, e.g.*, Kandel, *supra* note 114, at 408, 412 (“[P]ressure from the market for managers forces firms to develop the optimal compensation strategies, because otherwise they fail to attract talented managers ‘We must pay the market rates to attract and retain the necessary talent’ is a sentence frequently used”).

¹²⁶ *See* Walker, *supra* note 11, at 1826.

¹²⁷ *Id.* at 1830.

transparency regarding executive pay previously required by § 162(m)'s performance-based pay exception. Federal securities law still requires “clear, concise, and understandable disclosure about compensation” paid to top-level executives.¹²⁸ In the annual proxy statement, a company *must* disclose information concerning the amount and type of compensation paid to its top-level executives, and this disclosure must also illustrate the criteria used in reaching executive compensation decisions.¹²⁹ However, disclosure after the fact does not provide shareholders and third parties with the necessary level of information to “voice their opinions” regarding executive pay. Additionally, without § 162(m)'s performance-based pay exception, companies simply have greater flexibility in structuring incentive compensation awards that are less performance based and that provide for greater executive discretion.

This reduction in transparency may alter the forms of pay companies award their executives in the future, given there is no longer a tax incentive to award executives performance-based compensation.¹³⁰ This is quite troubling considering performance-based pay is one of the few ways to align the interests of executives and corporate shareholders, which ultimately ensures that executives remain accountable to shareholders (as noted above, theoretically, under performance-based pay programs executives are only paid when they achieve performance goals).¹³¹

Therefore, in an effort to incentivize companies to utilize performance-based pay practices that encourage executive accountability and corporate transparency, Congress should reward companies that implement these pay structures with a tax deduction. The original implementation of § 162(m) attempted to do this but was using the wrong metrics—easily enabling executives to artificially inflate stock prices—which counterintuitively misaligned the interests of executive management and corporate shareholders

¹²⁸ 17 C.F.R. § 229.402(a)(2) (2019).

¹²⁹ *Id.* § 229.402(b).

¹³⁰ Walker, *supra* note 11, at 1825.

¹³¹ This Note does not suggest that executives are without justification in being awarded substantial compensation. Executive pay is an ordinary and necessary business expense, which should be deductible under § 162(a) so long as it is reasonable. However, this Note does suggest that executive compensation has—and likely will continue to become—out of hand without a revision to the provision.

(and which also increased the overall level of executive pay).¹³² To correct this problem, the proposed revision of § 162(m) would limit a publicly held company's ability to take deductions for traditional equity awards, while providing deductions for performance-based pay that is truly indicative of an executive meeting a reasonable, long-term performance goal. The remainder of this part discusses this proposed revision in greater detail.

A. Pay Ratio Requirement Between Covered Employees and Average Workers

First, to qualify for the “new performance-based exception,” companies should be required to meet a ratio requirement that measures the amount of compensation paid to the companies' lowest-level employees as compared to the companies' covered employees in order to satisfy the reasonableness requirement set forth in § 162(a). This would be similar to the surcharge or “inequality tax” some cities have begun imposing on companies that pay executives significantly more than average workers. For instance, the City of Portland recently imposed a surcharge on companies whose CEOs earn more than 100 times the median pay of their average workers.¹³³ Under the proposed revision to § 162(m), a formal surcharge would not be imposed on the compensation paid to executives that exceeds the ratio; however, they would lose the ability to claim the performance-based pay exception under the revised provision.

To incentivize companies to adhere to this requirement, the ratio would need to be set at a level that would discourage companies from increasing executive pay at such extraordinary rates (i.e., most companies would likely forgo attempting to qualify for the exception if the ratio required the

¹³² Common performance metrics such as earnings per share can easily be manipulated using stock buybacks. Under this scenario, a company could repurchase its own stock, thereby reducing the number of outstanding shares in the market, and artificially boost earnings per share—increasing the value of the shares held by executives.

¹³³ PORTLAND, OR., CITY CODE § 7.02.500(E) (“Pay Ratio Surtax applicable to publicly traded companies subject to U.S. Securities and Exchange Commission pay ratio reporting requirements . . . a surtax of 10 percent of base tax liability is imposed if a company subject to this section reports a pay ratio of at least 100:1 but less than 250:1 on U.S. Securities and Exchange Commission disclosures . . . a surtax of 25 percent of base liability tax is imposed if a company subject to this section reports a pay ratio of 250:1 or greater on U.S. Securities and Exchange Commission disclosures.”).

companies to significantly reduce their executives' current compensation). Most recently, the Economic Policy Institute reported that the average CEO in America made roughly 278 times more than the average worker.¹³⁴ Additionally, the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) reported that the average S&P 500 CEO made roughly 287 times more than the average worker in 2018.¹³⁵ Congress should take these figures into account in determining the necessary ratio to incentivize companies to meet the requirement. As such, under the proposed revision, a company might fail to qualify for the exception if any of the company's covered employees earned more than 300 times the compensation of the lowest salaried employee of the company (a ratio of 300:1) during the taxable year.¹³⁶ Using this ratio, if the lowest salaried employee of a company earned \$40,000 per year, the company would fail to qualify for the exception if any of its covered employees' total compensation earned during the year exceeded \$12 million (\$40,000 x 300).

Mandating this requirement would result in three possible outcomes: (1) the company could cap its covered employees' total compensation packages at \$12 million, or 300 times that of the lowest salaried employee; (2) the company could begin raising the salaries of the company's lowest paid workers to increase the total compensation that could be awarded to covered employees while still qualifying for the deduction (i.e., if a company increased the pay of the lowest salaried employee to \$45,000, it could then award its covered employees \$13.5 million during the taxable year and still qualify for the exception); or (3) the company could disregard the requirement and fail to qualify for the exception entirely.

The first two outcomes both have positive effects. Under the first outcome, § 162(m) is working as it should; it is limiting the amount of "excessive" compensation being awarded to the company's executives and

¹³⁴ MISHEL & WOLFE, *supra* note 69.

¹³⁵ *Executive Paywatch*, AFL-CIO, <https://aflcio.org/paywatch> (last visited Aug. 16, 2019).

¹³⁶ Although a ratio of 300:1 appears rather significant, this limitation would prevent the ratio from reaching all-time highs (i.e., in 2017, the average CEO-to-worker compensation ratio was 312:1). See LAWRENCE MISHEL & JESSICA SCHIEDER, ECON. POL'Y INST., CEO COMPENSATION SURGED IN 2017 (2018), <https://www.epi.org/publication/ceo-compensation-surged-in-2017/>. Therefore, by implementing this requirement, Congress could effectively "rein in" executive pay. See DAVIS & MISHEL, *supra* note 27.

thus reining in executive pay. Under the second outcome, although § 162(m) is not preventing the company from increasing its covered employees' pay, it is increasing the level of pay being awarded to the company's lower-level employees, reducing the disparity in pay between the company's top executives and lowest-paid employees. Finally, under the third outcome, the company would lose its ability to qualify for the exception, and the company would be required to pay tax on all of its executive compensation in excess of \$1 million. However, if the ratio was set at an appropriate level, an argument could be made that many companies would attempt to meet the stated ratio in fear of how employees would react, furthering Congress's original intent to rein in excessive executive compensation.¹³⁷ It would be impractical to attempt to set the pay ratio at a level mirroring the executive-to-average-worker ratios of the mid-to-late 1980s and early 1990s (roughly 122:1)¹³⁸ because that would require companies either to dramatically reduce the level of compensation paid to executives or to significantly raise the wages of the average worker. However, if the pay ratio was set at a level that prevented the current executive-to-average-worker ratio from growing at such a dramatic rate, companies could still handsomely pay their executives without exacerbating the dramatic pay gap that currently exists in the United States.

B. The Use of Better Metrics

1. The Removal of Stock Options from the Exception

The next proposed revision to § 162(m) would eliminate stock options from nearly automatically qualifying for the exception, as previously permitted. As a result of the original implementation of § 162(m), stock

¹³⁷ See Jena McGregor, *As Companies Reveal Gigantic CEO-to-Worker Pay Ratios, Some Worry How Low-Paid Workers Might Take the News*, WASH. POST (Feb. 21, 2018, 5:51 PM), <https://www.washingtonpost.com/news/on-leadership/wp/2018/02/21/as-companies-reveal-gigantic-ceo-to-worker-pay-ratios-some-worry-how-low-paid-workers-might-take-the-news/>; Bhavya Mohan & Michael I. Norton, *Consumers Care About CEO-Employee Pay Ratios*, WALL ST. J. (May 20, 2018, 10:05 PM), <https://www.wsj.com/articles/consumers-care-about-ceo-employee-pay-ratios-1526868301>.

¹³⁸ DAVIS & MISHEL, *supra* note 27.

options and other forms of equity-based pay became the primary method of compensating executives at publicly held companies.¹³⁹

Between 1993 and 2001, median pay for S&P 500 CEO's increased from \$3.1 million to \$10 million (in 2016 dollars), and the growth was almost entirely in the form of cash bonuses and equity compensation, principally stock options, which alone accounted for more than half of the compensation of the median S&P 500 CEO in 2001.¹⁴⁰

Stock options became the compensation of choice because they did not need to meet the stringent standards applied to other types of performance-based compensation, provided that the requirements for outside director and shareholder approval were met, because the amount of compensation attributable to the options or other rights received by the executive would be based solely on an increase in the company's stock price.¹⁴¹

However, stock price and other earnings-based metrics are poor measures of executive performance because "stock price is not always linked to the performance of the executive or the corporation."¹⁴² Additionally, earnings-based metrics can be easily manipulated through the implementation of stock buyback programs, dividend payouts, and merger and acquisition deals.¹⁴³ A stock buyback is when a company repurchases its own shares of stock from the marketplace.¹⁴⁴ The problem with stock buybacks in the executive compensation context is that a company's stock

¹³⁹ Walker, *supra* note 11, at 1822 (citing Kevin J. Murphy & Michael C. Jensen, *The Politics of Pay: The Unintended Consequences of Regulating Executive Compensation* 58 (Univ. S. Cal. Ctr. for Law & Soc. Sci. Legal Studies Papers Series, Paper No. 18-8, 2018)).

¹⁴⁰ *Id.*

¹⁴¹ STAFF OF JOINT COMM. ON TAXATION, *supra* note 3, at 2–8.

¹⁴² Conway, *supra* note 16, at 409.

¹⁴³ See Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, 17 J. ECON. PERSP. 49, 61–62 (2003); Michael diFilipo, Note, *Regulating Executive Compensation in the Wake of the Financial Crisis*, 2 DREXEL L. REV. 258, 268–69 (2009); Portia Crowe, *CEOs Love Share Buybacks for the Most Obvious Reason in the World*, BUS. INSIDER (July 7, 2015, 2:48 PM), <https://www.businessinsider.com/one-big-reason-to-be-skeptical-about-buybacks-and-dividends-2015-7>.

¹⁴⁴ Robert J. Rhee, *Intra-Firm Monitoring of Executive Compensation*, 69 VAND. L. REV. 695, 705 (2016) (providing evidence that payout policy and stock buybacks have been improperly affected by consideration of CEO wealth (citing ASWATH DAMODARAN, CORPORATE FINANCE: THEORY AND PRACTICE 687 (2d ed. 2001) (defining stock buybacks and supporting the proposition that executives attempt to manipulate stock price through payout policies))).

price is calculated by dividing the company's total value (i.e., market capitalization) by the number of outstanding shares currently available in the market.¹⁴⁵ Therefore, when a company buys back its own shares, it is essentially reducing the denominator in the ratio used to determine the company's stock price without changing the numerator (i.e., the company's value), artificially inflating the company's stock price. One can see why this might be troubling, as an executive could simply drive a company into the ground, subsequently get the board of directors to approve a stock buyback, and profit despite poor executive performance. Since TCJA's enactment, it has been reported that "[t]en of the largest U.S. companies combined to buy back more than a quarter-billion dollars of their own stock in 2018."¹⁴⁶ The average CEO compensation for these same companies during this time was \$30.8 million.¹⁴⁷

Executives can also manipulate their companies' stock prices by declaring dividends or acquiring other companies.¹⁴⁸ For instance, when a company reduces the dividends it pays on its stock, the stock becomes less attractive to investors.¹⁴⁹ Conversely, if a company decides to increase the dividends it pays on its stock, the stock becomes more attractive to investors.¹⁵⁰ This same tactic can be used in the mergers and acquisitions context.¹⁵¹ When a company sells parts of its business, the company's stock

¹⁴⁵ *Market Capitalization*, BUSINESSDICTIONARY, <http://www.businessdictionary.com/definition/market-capitalization-market-cap.html> (last visited July 7, 2019) ("On-going market valuation of a public firm (whose shares are publicly traded) computed by multiplying the number of outstanding shares (held by shareholders) with the current per share market price. It is, however, not necessarily the price a buyer would pay for the entire firm. And [it] is not a realistic estimate of the firm's actual size, because a share's market price is based on trading in only a fraction of the firm's total outstanding shares.").

¹⁴⁶ *Executive Paywatch*, *supra* note 135.

¹⁴⁷ *Id.*

¹⁴⁸ Mitchell Grant, *How Dividends Affect Stock Prices*, INVESTOPEDIA, <https://www.investopedia.com/articles/investing/091015/how-dividends-affect-stock-prices.asp> (last updated June 30, 2019); Chris B. Murphy, *How Company Stocks Move During an Acquisition*, INVESTOPEDIA, <https://www.investopedia.com/ask/answers/203.asp> (last updated June 25, 2019).

¹⁴⁹ Grant, *supra* note 148.

¹⁵⁰ *See id.*

¹⁵¹ Murphy, *supra* note 148.

generally becomes less attractive.¹⁵² On the other hand, when a company begins acquiring other businesses, the company's stock generally becomes more attractive.¹⁵³

In addition to enabling executives to artificially inflate stock prices, both of these tactics also create an agency cost problem between shareholders and executives regarding corporate cash holdings.¹⁵⁴ “The decision of how to deploy internal funds is central to the conflict between shareholder expectations and management decision making.”¹⁵⁵ How much cash a company holds directly impacts whether management will decide to pay dividends or engage in acquisitions.¹⁵⁶ “Although it is optimal for firms to hold some cash to finance day-to-day operations and to provide a buffer against the cost of externally financing their investments, holding excessive cash resources may have negative value implications if managers use these liquid resources inefficiently.”¹⁵⁷ “Cash reserves are easily accessible by management with little scrutiny and much of their use is discretionary.”¹⁵⁸ “The central tradeoff in cash policy is providing sufficient internal capital for managers to efficiently fund good projects, while not providing excess internal capital as to allow managers to fund projects, acquisitions or perquisite consumption that benefit managers at the expense of shareholders.”¹⁵⁹

However, because a company will not normally pay dividends or buy other companies unless they themselves are profitable (because dividends are directly paid out of the company's retained earnings and because capital is required to buy businesses), these scenarios are not quite as troubling as the stock buyback example above, although a company may take on significant

¹⁵² *Id.*

¹⁵³ *Id.*

¹⁵⁴ Tracy Xu & Bo Han, *Managerial Incentives and Corporate Cash Holdings*, 14 J. APPLIED BUS. & ECON. 72, 72 (2013).

¹⁵⁵ *Id.*

¹⁵⁶ *Id.* at 82.

¹⁵⁷ *Id.* at 72.

¹⁵⁸ *Id.*

¹⁵⁹ *Id.* at 73.

debt to obtain the funds necessary to purchase another company.¹⁶⁰ Nevertheless, because executives may (1) be motivated to hold cash at the expense of shareholders' expectations and (2) arbitrarily inflate stock prices (giving executives discretion over their pay), stock price and earnings-based metrics should not be used as the primary indicators of executive performance.

Therefore, under the proposed revision to § 162(m), stock options would be completely eliminated from the exception. However, other forms of equity-based compensation that give executives less discretion over their pay, such as restricted stock and restricted stock units, would not fail to qualify for the exception so long as certain measures were implemented to prohibit an executive from receiving unwarranted compensation. "Restricted stock is stock that is transferred to an employee as compensation for services, subject to a vesting schedule."¹⁶¹ Essentially, the company has a contractual right to repurchase a portion of the stock if the employee leaves (before the stock fails to vest) or does not meet performance metrics.¹⁶² Although restricted stock does give an executive some discretion over their pay (i.e., they can determine when to "cash in" after vesting), "restricted stock is less likely to leave an executive unincentivized after a fall in market price" due to the company's repurchase rights.¹⁶³ Further, "restricted stock does not encourage an executive to favor stock buybacks or reduce dividend plans; thus, restricted stock eliminates many of the most prominent flaws found in conventional stock options."¹⁶⁴

Under the proposed revision, restricted stock awarded to an executive would fail to qualify for the exception if "stealth compensation" was awarded prior to the restricted stock's vesting date. Stealth compensation is compensation granted to top-level executives that is either (1) not required to

¹⁶⁰ Laura Femino, Note, *Ex Ante Review of Leveraged Buyouts*, 123 YALE L.J. 1830, 1834 (2014) ("An LBO is the acquisition of a target company financed by debt that is secured by the assets of the target company and paid with the target's future cash flows.").

¹⁶¹ G. Edgar Adkins, Jr. & Jeffrey A. Martin, *Restricted Stock: The Tax Impact on Employers and Employees*, 107 J. TAX'N 224, 224 (2007).

¹⁶² *See id.*

¹⁶³ diFilipo, *supra* note 143, at 271.

¹⁶⁴ *Id.* at 271–72.

be disclosed or (2) disclosed in a way that is difficult for the average investor to comprehend.¹⁶⁵ This commonly occurs when dividends are awarded to an executive on their unvested restricted stock grants (i.e., stock not yet owned by the executive).¹⁶⁶ For instance, in 2017, JPMorgan Chase paid CEO Jamie Dimon \$210,000 in dividends on his unvested restricted stock shares.¹⁶⁷ This type of compensation would trigger the restricted stock to fail to qualify for the exception because it “influences decisions involving dividend policy by creating incentives for companies to increase its dividend payout, which could either reduce or exacerbate agency issues.”¹⁶⁸ As such, under the proposed revision to § 162(m), other forms of equity-based compensation that do not provide as much executive discretion could qualify for the exception; however, measures would need to be implemented to eliminate the allowance of stealth compensation, once again more closely aligning the interests of executive management and corporate shareholders while also promoting corporate transparency.

2. Bonuses for Achieving Long-Term Performance Goals

Because the overall goal of the proposed revision to § 162(m) is to promote executive accountability and corporate transparency by tying executive pay to *actual performance*, which assists in ensuring compensation awarded to top-level executives is reasonable,¹⁶⁹ cash bonuses and other performance-based incentives would also be permitted under the revision (in fact, they would be highly encouraged). As noted above, stock options have proved to be a poor measure of executive performance because stock prices can be easily manipulated. However, cash bonuses and other performance-based incentives that encourage long-term success and that are contingent on satisfying business metrics are much more difficult to manipulate than stock prices when shareholders approve reasonable performance goals.

¹⁶⁵ Kristina Minnick & Leonard Rosenthal, *Stealth Compensation: Do CEOs Increase Their Pay by Influencing Dividend Policy?*, 25 J. CORP. FIN. 435, 435 (2014).

¹⁶⁶ *Id.*

¹⁶⁷ Aaron Elstein, *JPMorgan Chase Execs Get Paid Money for Nothing (And the Checks Are Free)*, CRAIN’S N.Y. BUS. (Mar. 22, 2018, 12:00 AM), <https://www.crainnewyork.com/article/20180322/FINANCE/180329937/jpmorgan-chase-execs-get-paid-money-for-nothing-and-the-checks-are-free>.

¹⁶⁸ Minnick & Rosenthal, *supra* note 165, at 435–36.

¹⁶⁹ STAFF OF JOINT COMM. ON TAXATION, *supra* note 3.

First, long-term incentives force executives to focus on the overall growth and well-being of the companies they work for. Executives would not benefit by increasing a company's share price in the short term. Executives would only benefit when the company actually performs well over a longer period of time. Second, business metrics are better measures of executive performance because (1) they are not as sensitive to outside factors that bear no relationship to executive performance (e.g., inflation) and (2) they do not encourage executives to engage in as much risky behavior as earnings metrics do. For instance, consider a company that offers an executive a cash bonus for increasing the company's sales revenue over the next three years. The executive may implement a new strategy to increase the company's sales revenue during this period in hopes of being awarded the bonus. However, although the executive's motive for increasing the company's sales revenue is purely personal, the company and its shareholders are not at risk because sales revenue cannot be artificially manipulated. Executives either meet the performance goals or they do not. Therefore, under the proposed revision to § 162(m), companies would be permitted to take a deduction for bonuses paid to executives upon meeting certain business metrics that support their companies' long-term success (as opposed to earnings metrics that generally promote short-term growth).

Ideally, this deduction would incentivize companies to pay their executives more like professional athletes, to whom cash bonuses are awarded for meeting performance goals and athletic achievements.¹⁷⁰ Like athletes, executives participate in a highly competitive labor market, and professional athletes' contracts are loaded with incentives and opportunities for them to earn more than their stipulated salary amount. In the baseball context, a player may be awarded bonuses for playing in a certain number of games, getting a certain number of hits, or batting above a certain average.¹⁷¹ Essentially, the player is only awarded additional incentives if the player performs well. If the player does not perform well, the player is not entitled to the incentives.

¹⁷⁰ See Greg McFarlane, *Pro Athletes Can Score Winning Bonuses*, NBC NEWS (Feb. 7, 2012, 12:21 PM), <http://www.nbcnews.com/id/46170005/ns/business-careers/t/pro-athletes-can-score-winning-bonuses/#.XeXROJNKh0s>.

¹⁷¹ *Id.*

Likewise, under the proposed revision to § 162(m), companies would be incentivized by means of a tax deduction to award bonuses to executives for meeting similar business “milestones,” such as improving the company’s operating margin, reducing the company’s expense ratio, or increasing the company’s sales revenue.¹⁷² These metrics are not tied to the company’s earnings, and therefore, cannot be easily manipulated. Additionally, the majority of business metrics are better indicators of a company’s long-term success than earnings metrics are.¹⁷³ This proposed revision would highly encourage companies to restructure executive compensation programs in favor of cash-bonus models, which would (1) more appropriately tie executive pay to actual performance (i.e., executives would only be paid when they achieved performance goals) and (2) promote long-term growth in the private sector.

VI. CONCLUSION

Because publicly held companies will likely continue to offer executives equity-based awards despite TCJA’s recent expansion of § 162(m), potentially enabling executive pay to reach new heights, Congress should reinstate a revised performance-based pay exception into § 162(m) to incentivize companies to leverage alternative forms of performance-based compensation. Although this proposed revision would still enable corporate executives to be awarded significant pay, by incentivizing companies to shift their executive compensation practices away from the granting of stock options, the interests of executives and shareholders would be more closely aligned. This alignment of interest coupled with the use of better metrics that promote corporate transparency and executive accountability would directly benefit shareholders and should help to curtail the overall level of executive compensation in the future.

¹⁷² RICHARD DOBBS & TIMOTHY KOLLER, MCKINSEY & CO., MEASURING LONG-TERM PERFORMANCE (2019), <https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/measuring-long-term-performance>.

¹⁷³ See generally Michael J. Mauboussin, *The True Measures of Success*, 90 HARV. BUS. REV., no. 10, 2012, at 48.