CEO STOCK(ING) STUFFERS

HOW A 20-YEAR-OLD RULE INTENDED TO CONTROL CEO PAY HAS BLOATED EXECUTIVE PAYCHECKS WHILE DRAINING TAX REVENUE AND WIDENING INEQUALITY

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20th Anniversary of a Taxpayer Subsidy for CEO Pay

Twenty years ago – on December 20, 1995—the U.S. Treasury Department finalized a tax rule designed to rein in soaring executive pay. Section 162(m) of the tax code instead sparked an explosion in CEO compensation and a decline in corporate taxes while exacerbating the country's wealth divide.

The Clinton administration had pushed through legislation to create this new tax rule in 1993. The bill limited the amount of compensation costs that a corporation could deduct to no more than $1 million per executive per year. But the bill had a huge loophole: corporations could deduct unlimited amounts of pay, so long as the pay was based on company performance.

Companies responded by stuffing CEO pay envelopes with fully deductible stock options, performance shares, and other bonuses tied to performance triggers. Essentially, the "performance pay" loophole meant that the more companies pay their CEOs, the less they pay in taxes—and the rest of us make up the difference. Americans who have seen their wages stagnate are forced to have their tax dollars used to subsidize the pay of those who sit atop America's largest businesses.

Through analysis of Fortune 500 company proxy statements, we identified the 10 corporations that benefited the most from this loophole in 2014. These corporations combined cut their tax bills by more than $182 million through "performance pay" deductions related just to their CEOs. The loophole applies to four top executives at each company (see appendix for details). The Joint Committee on Taxation estimates that eliminating this loophole for all companies would generate $50 billion in revenue over 10 years.

The 10 largest corporate beneficiaries of the 'performance pay' loophole in 2014

Company	CEO	Portion of compensation that is "performance-based"	Value of corporation's CEO "performance pay" subsidy
McKesson	John Hammergren	111,860,550	39,151,193
Disney	Robert Iger	64,285,599	22,499,960
American Express	Kenneth Chenault	45,310,022	15,858,508
Cardinal Health	George Barrett	45,091,572	15,782,050
Tesoro	Gregory Goff	43,535,667	15,237,483
Mondelez	Irene Rosenfeld	43,254,106	15,138,937
Allstate	Thomas Wilson	42,968,840	15,039,094
Honeywell	David Cote	41,896,000	14,663,600
Comcast	Brian L. Roberts	41,534,354	14,537,024
Wells Fargo	John Stumpf	40,434,254	14,151,989
Total		**520,170,964**	**182,059,837**

Sources and methodology: see appendix.

By far the largest beneficiary of the "performance pay" loophole last year was the pharmaceutical wholesaler McKesson. CEO John Hammergren pocketed $112 million in fully deductible "performance pay." This included more than $60 million in stock options, $40 million in vested performance stock, and more than $10 million in bonuses tied to performance criteria. That translates into a $39 million taxpayer subsidy for the company, assuming a 35 percent corporate tax rate.

The 'performance pay' loophole deepens wealth inequality

The stock-pay incentives created by this loophole have played a powerful role in deepening wealth inequality. Twenty CEOs who are not company founders hold more than $300 million worth of stock in their corporations (see table below). In contrast, American households' median net worth (including stock as well as property and other assets) is only $81,400.

Non-founder CEOs with more than $300 million of stock in their corporations

Corporation	CEO	Shares Owned (#)	Price per share as of 12/17/15	Total stock value
Alphabet (formerly Google)	Eric E. Schmidt	4,464,597	749.43	3,345,902,930
Gilead Sciences	John C. Martin	10,598,699	102.36	1,084,882,830
Allergan	David E.I. Pyott	2,811,313	309.51	870,129,487
Honeywell	David M. Cote	6,827,440	102.31	698,515,386
J P Morgan Chase	James Dimon	9,945,379	66.28	659,179,720
American Financial Group	Carl H. Lindner III	8,375,336	68.34	572,370,462
Goldman Sachs	Lloyd C. Blankfein	3,120,176	182.61	569,775,339
Coca-Cola	Muhtar Kent	12,281,136	43.59	535,334,718
McKesson	John Hammergren	2,272,922	190.02	431,900,638
Celgene	Robert J. Hugin	3,840,755	110.65	424,979,541
UnitedHealth Group	Stephen J. Hemsley	3,555,559	119.22	423,893,744
Disney	Robert A. Iger	3582141	112.01	401,246,360
Aetna	Mark T. Bertolini	3,504,313	108.86	381,479,513
NIKE	Mark G. Parker	2,820,898	130.22	367,337,338
AFLAC	Daniel P. Amos	5,832,192	60.38	352,147,753
Hormel Foods	Jeffrey M. Ettinger	4403043	79.49	349,997,888
American Express	Kenneth I. Chenault	4667190	69.57	324,696,408
CBS	Leslie Moonves	6,766,664	46.52	314,785,209
Time Warner	Jeffrey L. Bewkes	4,683,812	64.86	303,792,046
YUM Brands	David C. Novak	4,162,412	72.20	300,526,146
Total				**12,712,873,457**
Average				**635,643,673**

Sources and methodology: see appendix.

Efforts to rein in excessive CEO pay have a long history. At the end of World War I, there was a public outcry over the pay of railroad executives whose firms were nationalized during the war. The onset of the Great Depression a decade later increased public anger over the wide disparities between those running America's businesses and the millions of Americans thrown out of work. Congress responded to public rage by requiring the disclosure of CEO pay under the Securities Act of 1934. But it was not disclosure as much as the high marginal income tax rates (as high as 91 percent) put in place at the end of World War II that succeeded in checking CEO pay.

Starting in the 1950s, stock options, which give executives the right to purchase stock at a fixed priced (usually the market price on the grant date), started to become a popular form of compensation. In the 1960s, grants of stock units were increasingly added to pay packages. Such stock based-pay was touted as a means of boosting shareholder value by aligning the interests of company executives and shareholders. But instead of encouraging high performance, options and stock grants created strong incentives to take huge short-term risks— risks that contributed to the 2007-08 financial crisis.

Congress responded by including several executive pay provisions in the Dodd-Frank financial reform. Some of these are yet to be finalized, including a ban on pay packages in the financial sector that encourage "inappropriate risk." Others, such as a requirement to allow shareholders to vote on executive pay plans, are non-binding.

This past August, the SEC finalized a key Dodd-Frank provision requiring companies to disclose the ratio of CEO pay to the median pay of their workers. This was an important step, but some corporate groups have been threatening legal challenges, arguing that corporate free speech rights give them the right to conceal such information. Ending taxpayer subsidies for excessive CEO pay would be an important addition to these reform efforts.

The Obamacare Precedent

Policymakers did not want the benefits of the Affordable Care Act (commonly known as Obamacare) to be funneled into the pockets of corporate executives. And so they capped the deductibility of executive compensation at $500,000 per executive— with no exceptions for "performance pay."

The cap applies only to health insurance companies, not others that have benefited from the expanded pool of insured customers, including pharmaceutical distributors like McKesson.

With the cap only applying to a handful of firms, it's not surprising that the insurance companies have not responded by lowering executive pay. For example, Stephen Hemsley, CEO of UnitedHealth, the nation's largest insurer, received a 23 percent raise to $14.8 million in 2014, with 91 percent of compensation in forms that could've been fully deductible before the ACA.

And yet this Obamacare reform has set an important precedent for eliminating taxpayer subsidies for executive pay.

Legislation to eliminate the "performance pay" loophole

The Affordable Care Act (the "ACA," also known as "Obamacare") set an important precedent for eliminating the "performance pay" loophole, but only in the health insurance industry. Under the ACA, health insurers that participated in government-subsidized health insurance exchanges can deduct no more than $500,000 in compensation per executive; there are no exceptions for performance-based pay. Several bills pending in the U.S. Congress take slightly different approaches to extending this important precedent to all U.S. firms:

- Stop Subsidizing Multimillion Dollar Corporate Bonuses Act (S. 1127 and H.R. 2103)) would eliminate the "performance pay" exemption. A meaningful tax deductibility cap would eliminate a perverse incentive for excessive compensation. The Joint Committee on Taxation estimates that this bill would generate $50 billion in revenue over 10 years.

- Income Equity Act (H.R. 1305) would deny employers a tax deduction for any excessive pay that runs greater than 25 times the median compensation paid to full-time employees or $500,000.

- Seniors and Veterans Emergency Benefits Act (SAVE Benefits Act, S. 2251 and H.R. 4012)) would eliminate the "performance pay" loophole in order to provide about 70 million seniors, veterans, people with disabilities, and others a one-time payment equal to 3.9 percent of the average annual Social Security benefit, or about $581. According to the Economic Policy Institute, CEOs of large U.S. corporations enjoyed a 3.9 percent raise last year.

- CEO-Employee Paycheck Fairness Act (H.R. 620) would deny corporate tax deductions for any executive compensation over $1 million, unless the firm raises salaries for lower-level workers.

Closing this loophole would be a step forward towards creating a fairer society and generating funds that can be used for greater public purpose.

Appendix: Sources & Methodology

1. *Largest beneficiaries of the performance pay loophole*

IPS and CEG analysis of Fortune 500 proxy statements filed with the SEC.

2. *Portion of compensation that is "performance-based"*

Internal Revenue Code Section 162(m) imposes a $1 million deduction limit for compensation to a company's CEO and its three other highest-paid executive officers (excluding the CFO), unless the compensation is "performance-based" and provided under a plan that has been approved by the shareholders. How 162(m) treats specific compensation package components:

Bonus: The type of compensation labeled "bonus" in the summary compensation table of corporate proxy statements is generally not considered performance-based because it is typically a cash payout awarded at the board's discretion rather than pursuant to a written plan approved by shareholders. However, some companies indicate in their proxies that they have configured this portion of compensation to be 162(m)-compliant.

Non-equity incentive plan compensation: Similar to a bonus, but paid under a written plan and thus considered "performance-based."

Stock options: Considered "performance-based." We included the value of options exercised, rather than the estimated value of a stock options grant, since options are not taxable until an executive exercises them.

Stock grants: Considered "performance-based" under 162(m) only when tied to specific performance benchmarks. Time-based restricted stock units do not qualify. Like stock options, stock grants are not taxable in the year they are granted, but rather when they vest. When the most recent proxy statement did not clarify whether stock vested that year had been structured to qualify for a deduction under 162(m), we looked at proxy information in the years in which the stock was granted. If it was still unclear, we did not include these amounts in our calculations.

Salary, perks, pensions, and nonqualified deferred compensation are not considered "performance-based."

3. *Value of corporation's CEO performance pay subsidy*

Corporations can deduct up to $1 million of each executive's compensation whether it is "performance-based" or not. Thus, when executives earned less than $1 million in non-performance-based pay, we deducted the difference from the "performance pay" total. To compute the tax break on qualifying "performance pay," we applied the federal corporate tax rate of 35 percent.

As with most tax matters, there is some gray area when it comes to deductions for executive compensation. Some companies note in their proxy statements that the IRS may challenge some of a firm's claimed deductions. Unfortunately, due to lack of transparency in corporate taxation, such challenges are not public information.

4. *CEO stock ownership*

Stock holdings are drawn from the most recent proxies as of September 4, 2015 and includes both shares presently owned and those that could be owned within 60 days if stock options were exercised (the SEC method for executive stock ownership reporting.) Closing stock prices on December 17, 2015 were used to calculate current values. Company founders were excluded because their stock ownership was not incentivized by 162 (m).