CEO Compensation

The Presidential Leadership Academy

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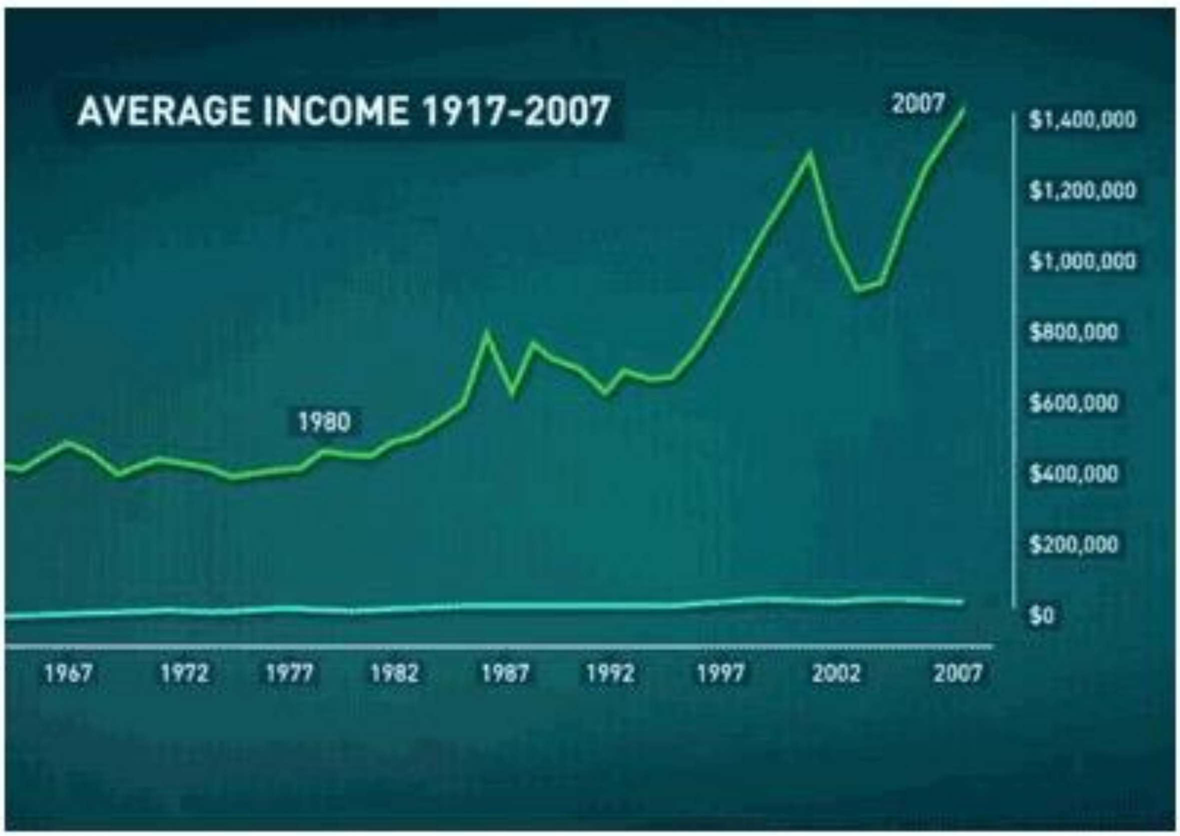
I. Nature of the Situation:

There has always been a significant gap between the wages of a CEO and the wages of their average worker. In 1960, a CEO would typically earn about 40 times the amount of his employees. (“History of Corporate Executive Wages”) While there is still a significant margin here, this rate seemed to demonstrate the worth of a CEO fairly well. However, the gap today has increased dramatically. In 2014, the average CEO made 296 times that of his average worker (Hiscott). Furthermore, it is not uncommon for a CEO to make 400 to 500 times the median salary of his/her employees (Stanford).



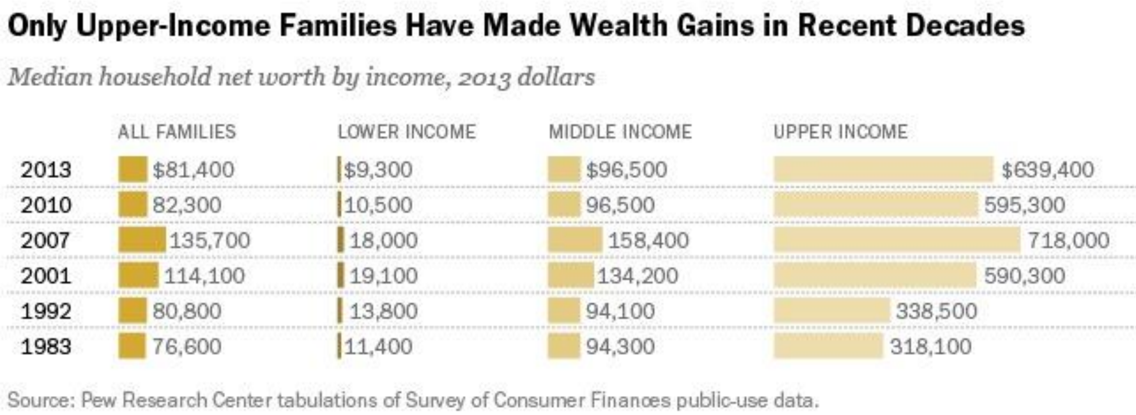
Credit: Dorsey Shaw; Source: Emmanuel Saez, UC Berkeley

The blue line shows the bottom 99%, while the green line shows the top 1%.

Americans are watching their CEOs get paid more and more, while their earnings have barely increased since the 1970's. The hourly wage has only increased by 9% in forty years, while the cost of living has increased 67%. Up through 2012, the top five percent of American families saw their salary increase by 74% but the bottom twenty percent of Americans saw their salary drop by 12%. Currently, the median salary for an American household is about $51,000, with $40,000 being declared a livable wage for a family of four ("Income Inequality"). On the other hand, the average CEO was paid $15.2 million (McDonnell). While the wealthiest continue to earn copious amounts of money, the federal minimum wage has declined sharply since the 1960's, when adjusted for inflation. The poorest Americans continue to struggle for financial stability.

The highest paid CEO is David Zaslav, of Discovery Communications, Inc. who made over $156 million in 2014. Others include Mario Gabelli of Gamco Investors, Inc. who made over $88 million, and Satya Nadella of Microsoft Corp. who made over $84 million in 2014 ("100 Highest Paid CEOs"). US CEOs have the highest compensation in the world (Stanford).

These statistics, when evaluated on a macro scale, paint a frightening picture of inequality in the American economy. The top one percent of Americans holds about 23% of the nation's wealth. The last time there was this much inequality was during the Great Depression ("Income Inequality"). This is an issue that all Americans are taking note of. 61% of Americans feel that the US economy favors the wealthy, including 45% of Republicans and 75% of Democrats (Desilver). And while most US citizens know the wage gap is unfair, many are unaware of just how large the gap really is.



What is causing this large wage gap? From 1936 through 1950, executive pay remained steady and was made up simply of a salary and a bonus. Then, around 1950, CEO pay started to include a small amount of stocks and options in the company. That trend grew more noticeable over the next 40 years, only to begin skyrocketing during the 1990s. In 1993, a change to the U.S. tax code capped deductions for executive pay at $1 million. But a loophole to the change allows “performance-based" income (pay packages like stocks that are directly tied to company's share performance, earnings or market share) to exceed the $1 million limit (“Two Decades of CEO Pay”). This loophole, found in Section 162(m) of the United States Tax Code, encourages companies to pay their CEOs outside of their base salary.

The argument for performance pay comes from Chicago-school economists Michael C. Jensen and Kevin J. Murphy, who published a hugely influential piece in the *Harvard Business Review* in the early 1990s, which argued executive pay should align CEO interests with what shareholders care about, which is higher stock prices. This idea has profoundly shaped the executive pay debate and is arguably the primary reason the performance pay loophole made it into the tax code.

Once Section 162(m) became law, predictably, companies started dispensing more compensation that qualified as performance pay, particularly stock options. Median executive compensation levels for S&P 500 Industrial companies nearly tripled in the 1990s, mainly driven by a dramatic growth in stock options ("Four Tax Loopholes").

The problem with this is that these 'performance' measures are usually not accurate. They are falsely exaggerated. In actuality, meeting these measures requires little effort on the part of the CEO. Through this loophole, CEOs overall avoided about $232 million in taxes ("Taxing Wealthy Americans").

There is currently no true cap on the amount of money corporations can deduct from their taxes for executive compensations. In 1993, the law limited deductions to $1 million, but corporations can still deduct performance pay. Corporations put money in special tax-deferred accounts, where large amounts of compensations can be shielded from taxes. CEO salary is taxed at 35%, but most of their compensation is in the form of capital gains. The capital gains tax is only 15%.

Corporations can report one set of information to shareholders and another to the Internal Revenue Survey. They aren't taxed on these stock options until much later when executives take money from them. By this time, the money has accumulated to the point that deductions are much greater.

Another tax loophole includes the fact that taxation rates on invested income--what did not get pocketed directly by CEOs--is much lower than earned income--what the average American family would take home as a salary. Additionally, CEOs that cut jobs took home 42%

more than the average CEO, creating a personal incentive for the CEO to cut jobs within his or her corporation. These sorts of loopholes incentivize executives to take large risks in their company in order to bring in more “performance based” pay.

Another large problem with CEO pay is Golden Parachutes. Designed as a way to attract top CEO talent to firms that are likely to go through mergers and acquisitions, these large payouts CEOs are promised should they lose their job prevent CEOs from thinking objectively about these deals. This incentivizes CEOs to accept offers that are not in the best interest of the firm while also being inherently unfair when looking at how regular employees are compensated when they lose their job under similar circumstances.

There are also tax breaks on special family trusts, such as the Wal-Mart Corporation. It has been passed down through families, so they are taxed virtually nothing for their multibillion dollar business. Additionally, those who list themselves as Self Employed (which includes many wealthy CEOs) escape all forms of the payroll tax. In fact, millionaires generally pay a lower tax rate than the average American.

Overall, these loopholes are losing an estimated 2.3 trillion dollars per year and putting the burden on lower income families. Performance Based Tax Loopholes alone lose 50 billion dollars per year (“Taxing Wealthy Americans”).

Currently, there are numerous bills that are circulating Congress, including the Stop Subsidizing Multimillion Dollar Corporate Bonuses Act (S. 1476) and its companion bill (H.R. 3970). These bills are attempting to end CEO performance based tax breaks. Representative Dave Camp of Michigan has also introduced a tax reform plan that would keep taxpayers from subsidizing a company’s top executive officers. However, neither of these bills have garnered much attention in the past couple years, and have not been furthered in any way ("Taxing Wealthy Americans").

II. Analysis of Fairness:

CEO compensation has risen dramatically in recent decades, especially in comparison to the median salary of employees. But has this trend created a system that is definitively unfair? Closely tied to the concept of fairness is merit. A CEO's merit is often considered to be the value the CEO creates for the firm, and the pay is designed to be commensurate with those contributions. Lou D'Ambrosio, former CEO of two fortune 500 companies, exemplified this principle with an example (D'Ambrosio):

There are two CEOs of different companies.

One CEO earns $1m/year and his company earns $10m/year.

The other CEO earns $2m/year and his company earns $30m/year.

Which CEO is being paid more? Now, which CEO is putting more money in the pockets of shareholders and employees?

D'Ambrosio makes the point that although the latter CEO is paid more than the former, the latter's pay is justified by his company's superior performance. The interesting philosophical component of D'Ambrosio's example is that he assumes the two CEOs are responsible for their respective company's performances.

Michael Dorff, a professor at Southwestern Law School, believes these kinds of justifications rest on "the flimsiest intellectual foundations… [that it is] possible to ascribe the performance of a big company to the individual who happens to sit in the executive chair" ("Moneybags"). Research from economists at New York University supports Dorff's beliefs, finding that the best CEO is statistically likely to increase earnings by .016 percent more than the 250^{th}-best CEO ("Worth Every Penny"). Even D'Ambrosio admits that a company's earnings growth cannot be entirely attributed to the contributions of its CEO. Factors outside of the CEO's control, like economic conditions and the overall health of the market, play a huge role in determining a company's success (D'Ambrosio). A byproduct of performance-related pay, a concept that will be explored further in our first policy, is that CEOs have financial incentives to hit certain performance targets since many executive compensation packages include options on a large numbers of shares.

If there are many external factors influencing a company's stock price, why then, is a CEO's pay tied to a firm's market value? In recent decades, average chief executive pay has grown by more than 500 percent, the same relative increase as the average value of the nation's top thousand firms ("Worth Every Penny"). The only way to justify this one-to-one increase is to assume that a CEO is directly responsible for the share performance of his company, which we know not to be true. Thomas J. Lehner, Director of Public Policy for Business Roundtable, believes these kinds of numbers indicate a fair system because they "show a direct correlation between levels of pay [and] market increase (Billitteri)." If, as Lehner asserts, the reason for the escalation in CEO pay is simply the share performance of the firms over which they preside, then we can reasonably expect the CEOs of the largest firms in nations experiencing similar rates of market growth to be paid similarly. However, in Japan, where the rate of market capitalization has soared, executive pay has not kept pace ("Worth Every Penny"). Compared to other nations, America is unique in the financial rewards CEOs are able to reap from their companies' growth.

A reason to be concerned about skyrocketing CEO pay is the disastrous consequences this trend has for employees and shareholders. A higher proportion of a company's profits is going to the CEOs ("Moneybags"). Essentially, this means there is less in retained earnings to be reinvested in the company or paid out to shareholders in the form of dividends. The shift in profit sharing also means diminished returns for working families that have their retirement savings tied up in pension funds (Billitteri). A growing pay gap between CEOs and average workers is detrimental to the morale of employees. Lawrence Mishel, President of the Economic Policy Institute, believes “being mindful of the income gap reflects a certain mindset in a corporation” (Hodgson). Corporations that widen this gap by rewarding their executives disproportionately risk losing productivity from their employees.

Though increases in a corporation’s executive compensation during times of stagnated wage growth is unfair to employees, the unfairness is exacerbated when viewed from a macro level. The original intention of performance-related pay was to get managers to work for the interests of their shareholders by essentially making them shareholders themselves. However, the unintended consequence of tying a CEO’s pay to a company’s share performance is that it has created strong incentives to manipulate stock prices through fraudulent accounting (Billitteri). The top executives of Enron and Lehman Brothers were both enthusiastic advocates of performance-related pay, and both of their companies, perhaps not coincidentally, engaged in the biggest accounting scandals in recent decades (“Moneybags”). Performance-related pay may be a motivating factor for CEOs to act in their own interests, but it is certainly not a motivating factor for them to act in the best interests of the country.

Other practices that on the surface seem sound are destabilizing the executive compensation structure and contributing to an unfair system. One such practice is the use of golden parachutes, in other words, payouts promised to top executives if a merger or acquisition results in the loss of their job. Golden parachutes create a set of circumstances in the event of a job loss for CEOs that is completely different than the guidelines under which lower-ranking employees operate. This is unfairness at its core—a two-tier system that benefits only the people at the top. Another critical component of fairness is accountability. The inadequate importance shareholders' opinion has in approving executive compensation packages is indicative of executives' lack of accountability. Say-on-pay votes are nonbinding, but mandated by recent financial reforms. Some companies continue to approve pay packages in spite of a lack of support from shareholders. Tightening the restrictions on golden parachutes and mandating a binding say-on-pay vote are two policies we propose in addition to eliminating performance-based-pay tax loopholes. These policies will encourage fair practices by putting more power in the hands of shareholders and employees.

In crafting our policies, we have taken into consideration differing opinions and have done our best to foresee the consequences. As D'ambrosio warned, it would be unwise to pass regulations that create a disconnect between the importance of the job and the compensation (D'Ambrosio). We believe that disconnect already exists, just in the opposite extreme. Our policy team also understand that professions with rigid salary structures tend to lose talent to professions with more flexible ones ("Moneybags"). Therefore, we seek to reform executive pay in a way that strikes a happy medium between the two types of systems. Nonetheless, it is the role of the government to correct for market inefficiencies. In the case of CEO pay, the data suggests that there is a large disparity between a CEO's compensation and the contributions a CEO could conceivably make. The escalation in pay cannot entirely be explained by the market demand for a CEO's skills nor the cost required to retain talent. It is a product of insufficient accountability. Executive salaries have been rising well beyond the rates of average workers' salaries regardless of gains in productivity, and if the public outcry is not enough to encourage corporations to change their ways, then increased regulation appears to be the only viable stimulus.

III. Policy #1: Eliminate Performance-Based Pay Tax Loophole

"The Law of Unintended Consequences"

The Internal Revenue Code, from here on referred to as the IRC, is a piece of fiscal legislation, which includes various forms of taxes. This section of this paper will focus specifically on the section that deals with taxation corporations must pay regarding their profits. There is a specific area of the IRC that critics are quick to refer to when considering potential defects in the law. Signed into law by President Clinton, Section 162(m) is the pinnacle of fiscal mistakes, so much so that it has been dubbed "The Law of Unintended Consequences". Section 162(m) has energized politicians and activists alike to revoke or rewrite the law, as it is too easily maneuvered by corporate tax analysts. The code is so obviously flawed, that Graef Crystal, an economic adviser under President Clinton, had degraded the policy's loose and navigable diction by saying, "...in 10 minutes even Forrest Gump could think up five ways around it" (Epstein, Javers).

Ironically, Section 162(m) was intended to curb an increasing disparity between executive and average worker pay but, in actuality, provided the means for the gap to dramatically increase. 162(m) states that publicly traded companies are allowed to deduct salary, stock grants, and bonuses paid to the top five executives, with some exceptions, from their taxable income, up to a value of $1 million (OBRA 1993). In short, a company can include an executive's salary, so long as it is equal to or less than $1 million, as an expense on their income statement so it is not counted toward its taxable profits. Corporations are typically taxed around 35% on their profits.

Though this clause attempts to explicitly reduce excessive executive compensation, 162(m) also includes a provision, which has enabled tax gurus to obtain some major gains for their clients. Corporations are allowed full tax deductibility for “performance-based” pay. Because of the advantages of full tax deductibility performance pay provides, 162(m) has not persuaded firms to reduce how much an executive is paid or to shorten the gap between the highest and average paid worker, but rather has encouraged companies to allocate pay from non-performance (salary, bonuses, and stock grants) to performance pay. In fact today, a CEO can expect 55% of his or her compensation to be based on performance (Balsam). The policy writers’ reasoning for including the pay for performance exception was the idea that a company should be able to enhance its CEO’s performance by incentivizing him or her with additional compensation if he or she does the job well. However, as it has already been discussed, the conjecture that an executive’s performance is linked to the value of his or her compensation package is refuted by many academics and economists.

What is “Performance-Based” Pay?

In order for pay to be qualified as “performance-based”, the IRS has a few requirements:

1. The executive must achieve preset certain goals, determined by an independent committee, in order to be qualified for the compensation.
2. The compensation package, created by the same committee mentioned above, must be approved by a simple shareholder majority.
3. The compensation package cannot be delivered until the committee assess if the preset goals have been accomplished.

These rules were established in order to mitigate the risk of companies abusing pay for performance to avoid tax-related burdens related to high executive pay. Though crafted with good intentions, the rules have their flaws. The next section will review these in greater detail

Questions of Fairness within the IRS Requirements: Questionable Objectives

There are inherent issues of fairness underlying these requirements. First, the IRS does not limit what can be considered a performance-based “objective” an executive must achieve in order to receive performance pay. The goals vary from measurable achievements, such as increase in stock price or higher market share, to more subjective objectives such as a healthier workplace environment or enhanced company culture. The latter has been the source of more scrutiny, as preset goals can be vague or difficult to measure quantitatively. For instance, Bellsouth Corporation’s CEO was required to attain, “individual achievement of personal commitments” in order to obtain his compensation package, and the AES Corporation credited its CEO’s performance pay due to a maintenance of a “fun” workplace environment (Epstein, Javers). Obviously, there is an inherent immeasurability of these goals, and such ambiguity may call into question the legitimacy of the compensation packages given to the CEOs who “achieved” them. Also, because goals like those above are so centered around the workplace, it may be difficult for the independent committee, the majority of whom do not actually work for the company, to accurately evaluate if they were accomplished.

Questions of Fairness within the IRS Requirements: Shady Shareholder Majority Vote

Another question regarding fairness about the IRS requirements concerns the second rule about a simple majority of shareholder approval of the preset goals. The relevance of the information given to shareholders regarding the composition of the pay and the difficulty for a CEO to achieve the goals has been called into question (Balsam). Steve Balsam, a professor of Accounting at Temple University, has studied this subject intensely. In his report “Taxes and Executive Compensation”, he comments on the issue of misleading or low quality shareholder information. He writes, “... only very general information is provided to shareholders. Therefore, shareholders are asked to, and usually do, approve plans without knowing whether the performance conditions are challenging or not, and the potential payouts from the plan.” But because the IRC does not have any requirements regarding the quality of the information given to shareholders, companies are able to operate in such a closed-door fashion. It is this sort of tricky maneuvering around rules, which the IRS requires companies to follow, that has further perpetrated wage inequality in America.

Composition of Performance Pay

When evaluating performance-based pay, it is important to understand how the executives are actually paid. That is, what are components of that compensation? The following section will look at the types of compensation CEOs can expect for performance pay and inherent inequities within them.

Non-performance pay such as salary, bonuses and stock grants are not of this paper’s concern as they are forms non-performance payment. Although it should be noted that, as time goes on, the line between performance and non-performance pay is becoming increasingly blurred. Most notably, stock grants have been evolving from a form of non-performance pay to performance pay. If companies attach performance-based goals on stock grants, then they can qualify as performance-based (Balsam). A firm can offer a stock grant to its executive if he or she achieves a goal related to stock price. For instance, an executive may only be eligible to receive a stock grant if the stock price reaches a certain level. In that case, if compliant with the other IRS requirements for performance pay, stock grants are likely to be fully tax deductible. This practice is, however, relatively new. (Balsam)

Performance pay can be simply broken down into four distinct categories: stock options, non-equity incentive plans, stock appreciation rights, and pension/deferred payment plans. The next part of the paper will describe each of them and how they relate to fairness.

Stock options are a form of payment similar to stock grants, but include an exercise price. Essentially what occurs is the following: a company offers an executive the opportunity to buy company stock at a certain price, after which they can sell the stock at a presumably higher rate in order to make a profit. The idea behind stock options is incentivizing the executive to perform well by making them a shareholder in the company. If the executive does not do well, then he or she runs the risk of lower the stock price, removing any chance for profiting from selling the stock. Though the theory behind this form of payment attempts to enhance an executive's performance, it has includes an unintended consequences.

Because CEOs want to profit from stock options, some more unethical executives have chosen to artificially or dishonestly raise their companies' stock prices. This fraud can have disastrous repercussions including, but not limited to, loss of shareholder wealth, loss of pension funding, and the destabilization of the national economy. An infamous example of this is Enron. Enron was an energy and eventual financial company who, under the direction of its CEO Jeffrey Skilling and board Chairman Ken Lay, used fraudulent accounting to make the company appear to be profitable, misrepresenting the value of the company and inflating its stock price. When the true reality of the situation came to fruition, the stock price plummeted, falling from its high of $90, and eventually hitting less than a dollar (Mulligan, Brooks). There were horrible consequences from this. Enron laid off thousands of workers, employees of affiliate companies lost pension plans, and $70 billion in shareholder equity vanished (Mulligan, Brooks). The worst part of this situation is the captains of the sinking ship that was Enron sold their pieces of the company for an exuberant before things got too bad. In the month prior to filing Chapter 11 bankruptcy, Enron handed out $745 million in cash and stock awards to its senior executives (Mulligan, Brooks). Unfortunately, the crimes of a few avaricious men penalized thousands of innocent people. On the brightside, however, Jeffrey Skilling is in prison for conspiracy and fraud.

Non-equity incentive plans are comparable to bonuses. That is, they are cash rewards. The difference has two facets. The first being that non-equity incentive plans are attached to a performance goal, aligning with the IRS' requirements for performance-based compensation. The second being that unlike bonuses, non-equity incentive plans have shareholder approval.

Stock appreciation rights, from here on referred to as SARs, are performance payments given to executives for increase the stock value of a company over a certain period of time. The executive is given a certain amount of stock at a certain price. Over the given time period, if the CEO successfully raises the price of his or her company stock, he or she is given the difference in value of the initial value of the package and the value of the package at the end of the period. They operate much like stock options, but rather than actually purchasing the equity, a CEO simply receives the difference between the value of the stock at the beginning of the SARs period, and the end.

Pension and deferred payment plans are both forms of compensation which executives are given after they no longer work for a company. A pension is given in one or a sequence of payments after an executive has retired. Deferred payments are given to executives who earned the money in one period, but receive it in another. Fiscally, the payments are a form of performance compensation as both are fully tax deductible. The reason for this is that when the payment is given, the recipient technically no longer works for the company, so the corporation is able to relieve itself for the tax burdens associated with excessive compensation.

In summary, all of the forms of performance-based compensation shown above are fully tax deductible and, as already stated, now comprise 55% of the average CEO's compensation (Balsam). A key concept to remember is that compensation is not necessary liquid, meaning it is not pure cash. Payments range from being cash-based to being equity-based. Regardless, all the forms of compensation explained above have value, which is taken from the company as a whole is given to a select few individuals.

The Repercussions of Performance Pay

There are two entities that are adversely affected by corporations' ability to increase the tax deductibility of their CEO's compensation: the average American and shareholders. Both, in some form, have privileges mitigated or burdens thrust upon them due to the current state of tax deductions through performance pay.

To begin, the taxpayer must fund an effective tax subsidy on executive compensation as the Treasury is hampered in the revenue it collects from the tax deductibility of performance-based pay. Take, for instance, 2010, when the US Treasury forfeited $7 billion in receivable taxes due to corporate deductions on performance based pay (Balsam). That revenue loss must be reconciled by allocating funds from other areas, thereby not allowing average Americans to enjoy the same government programs to the same degree. Thus, the American taxpayer effectively provides the fiscal means by which companies can pay their executives exuberant amounts of money. Even more bothersome is the revenue loss the Treasury faces as increased executive pay is taken from what would be taxable corporate profits. As executive pay increases, a company's taxable profits decrease, thereby reducing the amount of taxes it pays to the government. The chart below created by the Economic Policy Institute, aptly demonstrates this phenomenon, and its consequences.

Estimated tax savings/revenue loss as a result of executive compensation (billions of dollars)

	Total deductions	Tax savings at 15% rate	Tax savings at 25% rate	Tax savings at 35% rate
2007	$39.0	$5.9	$9.8	$13.7
2008	31.0	4.7	7.8	10.9
2009	23.6	3.5	5.9	8.3
2010	27.8	4.2	7.0	9.7
2007–2010	**121.5**	**18.2**	**30.4**	**42.5**

Source: Author's analysis of Capital IQ microdata

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Not only does the treasury suffer from $7 billion in tax deductions from performance-based pay, but it also must endure the financial burden of reduced company profits from excessive executive pay leading to reduced corporate taxes. As seen in the chart above, $121.5 billion in tax revenue was lost between 2007 to 2010 as companies reduce their profits by paying executives more, and thereby reduce the amount of money the Treasury receives from corporate taxation (Balsam).

The average American is also adversely affected by excessive executive pay as the types of performance-based pay, such as stock options, encourage some executives to artificially or fraudulently inflate their stock price to receive a bigger payout. As stated earlier, stock options are a form of performance payment where an executive is given the option to buy a piece of the company at a certain price, after which he or she can sell that stock at a hopefully higher price and make a profit. In order to achieve a price higher than the one at which they purchased the stock, some executives have used fraudulent accounting or short-term price boosting techniques to raise the price.

On a larger scale this artificial stock inflation strategy can destabilize markets, by creating stock market bubbles. These bubbles can have disastrous consequences when they burst, as seen in the housing crash of 2008. Large banks, like Lehman Brothers and Bear Stearns, underwent risky mortgage loans to make money, which in effect raised their respective stock prices. The bubble burst when many of those loans started to default and companies like Lehman Brothers started declaring bankruptcy. The bubble bursting spun the Western world into the most severe economic hardship since the Great Depression. Recessions and other hardships caused by destabilized markets endanger the welfare of uninvolved American citizens. Just to name a new of the burdens Americans endured in the case of the Great Recession of 2008, 30% of retirements savings in the stock market were lost, 44,000 businesses declared bankruptcy, and 3.5 million jobs vanished at the hands of a housing bubble engendered by artificial stock inflation (Bureau of Labor Statistics).

The second casualty of performance-based pay is the shareholders of a company. As company profits are transferred into executive compensation, cash payments, which could have returned back to the shareholders in the form of dividends or back to the company for investment in the form of retained earnings, is flooded a single or a few individuals. The company, when choosing to pay an executive more, sacrifices potential investment and shareholder return. One must consider, when viewing the situation from that particular perspective, that although the executives of a company may be responsible for the major strategic decision-making in a fiscal year, are they responsible for the success of the company to the same degree which they are paid? This is, obviously, difficult to quantify as there are several moving parts of large corporations that contribute to their growth and success is not an easily measured variable. However, the rate at which CEO compensation is growing is twice as much of the growth rate of the Dow Jones Industrial Average (Balsam). Meaning, the growth of executive compensation is rising twice as fast as the rate at which the value of their companies are growing. From this statistic, it is clear that executive compensation is extremely excessive and unmerited.

Policy

This chapter proposes a solution to the performance-based pay loophole with two facets. Rather than limit the maximum tax deductibility of executive pay to $1 million, we propose we revise the policy to a maximum of 50x that of the average worker's salary. Additional the tax deductibility of performance-based pay should be removed from the Internal Revenue Code.

First, instead of limiting the maximum tax deductibility of executive pay to $1 million, this paper proposes the IRC be revised so that the maximum amount a corporation can take off income statement as a form of an executive salary expense is 50x that of the average worker's salary. The reasoning for this proposition is a desire to squeeze the gap between the highest and average paid employees at a company. The 50x restriction gives a company two choices in order to avoid taxation: reduce CEO pay to closer follow that of the average worker or increase the average worker's salary to more closely follow the CEO's. This paper is not concerned with how much a company pays its CEO, but rather the difference between his or her salary and that of the company employees' salaries. Therefore, maintaining the 50x tax deductibility limitation between the two incentivizes a more equitable corporate compensation situation. A company can, and some very well may, pay their CEOs beyond the 50x limit, but the excess of that value will be subject to taxation. That taxation will be the same as the current: a statutory of about 35%.

The proposal to correct the obvious flaws surrounding “performance-based” pay is very obvious: amend the Internal Revenue Code to not include performance-based pay as tax deductible. This chapter aimed to demonstrate how the performance-based pay clause within Section 162(m) of the IRC has been easily navigated by tax analysts as to reduce their company's’ taxable income while also paying their executives exceedingly high wages. In short, the purpose of the performance-pay clause within the tax code is not being efficiently utilized and should, therefore, be eradicated from the law. The compensation inflation executives have seen over the last few decades and the unfair burdens this practice has thrust upon the American taxpayer and the company's shareholders have demonstrated the policy’s illegitimacy and clear consequences.

Appendix

Tax Deductibility

- Firms are taxed on their profits
  - Profit = Revenue - Expenses
  - Expenses (utilities, supplies, wages, etc.) are not counted towards profits, as they are subtracted as seen in the equation above.
    - Firms can count $1 million of their top 5 executives' pay as an expense so they are not taxed on it. However everything in excess of $1 million paid to an executive in the form of salary, bonuses, and stock grants *cannot* be counted as an expense and is subject to taxation.
- Example:
  - Firm A pays its CEO $1 million in salary, $1 million in bonuses, and $1 million in stock grants
    - Non-performance pay= Salary + bonuses + stock grants
    - Non-performance pay= $1 million + $1 million + $1 million= $3 million
    - Tax Deductibility limited to $1 million
    - Total non performance pay - tax deductibility = taxable pay
    - $3 million - $1 million = $2 million
      - Firm A must pay taxes on $2 million of CEO's non-performance pay

Stock Options

- Example:
    - Firm B offers its CEO the opportunity to buy 100 shares of common stock at the price of $1 per share.
        - CEO of Firm B buys 100 shares for $100.
    - One year later the price of Firm B's stock has risen to $2 after the executive updated the company's supply chain software, increasing efficiency.
        - CEO of Firm B sells 100 shares at $2 per share, receiving $200.
    - CEO of Firm B profits from stock options
        - Selling price - buying price = profit
        - $200 - $100 = $100

Stock Appreciation Rights (SARs)

- Firm C gives its CEO SARs with an initial value of 100 common stocks priced at $1, over the course of 1 year.
    - Value = Stock x Price at the beginning of the year
    - $100 = 100 common stock x $1
- At the end of the year, the stock price of Firm C is worth $2
    - Original Value = $100
    - New Value = Stock x Price at the end of the year
    - New Value = $200
- CEO of Firm C earns $100 in SARs
    - New Value - Old Value = Compensation
    - $200 - $100 = $100

IV. Policy #2: Restrict Golden Parachutes

Golden Parachutes are large cash bonuses, stock options, and other benefits CEOs and other top executives are promised should a merger or acquisition result in the dismissal of their job. These large payouts were originally designed to help recruit top talent to run a company in an industry that is prone to mergers and takeovers since the large payouts are enough to compensate for the decreased job security. Trans World Airlines in 1961 is accredited as the first company to give out a Golden Parachute. The company promised its chairman, Charles Tillinghast, Jr., a payout in the event that he lost his job. Tillinghast kept his job and never received his Golden Parachute, but a new form of executive compensation was created nonetheless ("Biggest Golden Parachutes").

In the late 1970s and early 1980s as the economy experienced unprecedented takeover activity, Golden Parachute use increased rapidly. Both the number of Golden Parachutes promised and the overall size of these payouts increased substantially during this time. In 1981, 15% of the 250 largest corporations in the United States had Golden Parachutes in place that covered nearly one third of the management contracts at these firms. By 1986, this increased by 18% to have 33% of the top 250 corporations having Golden Parachutes in place (Fiss, Kennedy, and Davis 1078). In 2011, the average golden parachute was over $30 million with many examples over $100 million ("Value of Golden Parachute Payments"). This is inherently unfair when the average employee receives only two weeks salary when they lose their job and CEOs are walking away with more than the average worker could make in dozens of lifetimes after losing their job. There have also been many situations where new CEOs have been brought in and worked for a small amount of time, failing to help the company and walking away with more money than most of the company's workers will make in their lifetime.

Company	CEO	Tenure	Total Payout
General Electric	John F. Welch Jr.	1981-2001	$417,361,902
Exxon Mobil Corp.	Lee R. Raymond	1993-2005	$320,599,861
UnitedHealth Group Inc.	William D. McGuire	1991-2006	$285,996,009
AT&T	Edward E. Whitacre Jr.	1990-2007	$230,048,463
Home Depot Inc.	Robert L. Nardelli	2000-2007	$223,290,123
North Fork Bank	John A. Kanas	1977-2006	$214,300,000
Merck & Co., Inc./Schering-Plough	Fred Hassan	2003-2009	$189,352,324
International Business Machines	Louis V. Gerstner Jr.	1993-2002	$189,005,929
Pfizer Inc.	Hank A. McKinnell Jr.	2001-2006	$188,329,553
CVS Caremark Corporation	Thomas M. Ryan	1998-2011	$185,415,435
Gillette Co.	James M. Kilts	2001-2005	$164,532,192
Target Corporation	Robert J. Ulrich	1994-2008	$164,162,612
Merrill Lynch & Co. Inc.	E. Stanley O'Neal	2002-2007	$161,500,000
U.S. Bancorp	Jerry A. Grundhofer	2001-2006	$159,064,090
Omnicare, Inc.	Joel F. Gemunder	2001-2010	$146,001,476
Wachovia/South Trust	Wallace D. Malone Jr.	1981-2004	$125,292,818
United Technologies Corporation	George A. L. David	1994-2008	$122,631,309
eBay Inc.	Margaret C. Whitman	1998-2008	$120,427,360
WellPoint Health Networks	Leonard Schaeffer	1992-2004	$119,041,000
XTO Energy Inc.	Bob R. Simpson	1986-2008	$103,485,972
Viacom	Thomas E. Freston	2006	$100,839,772

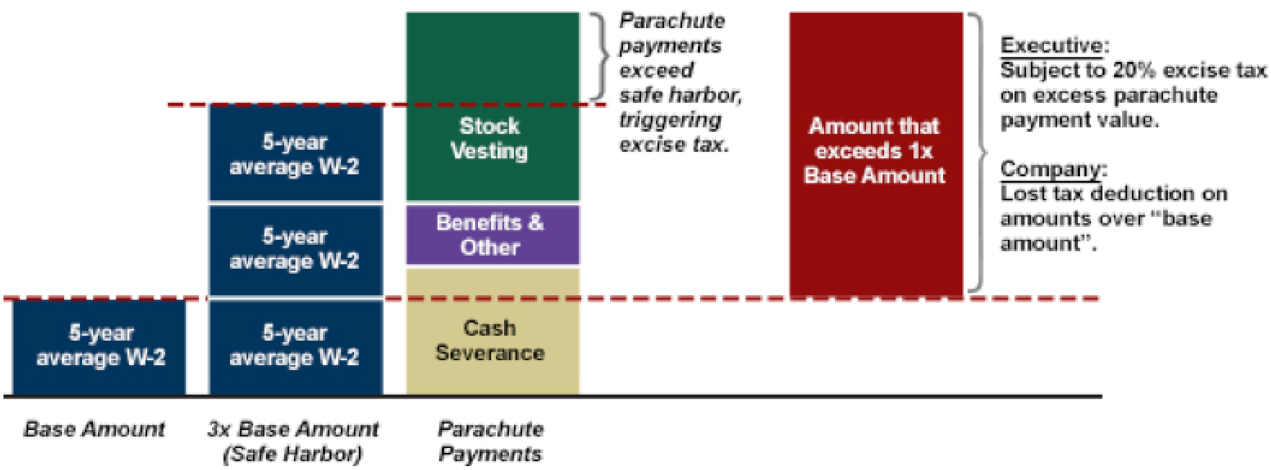
Examples of the largest US Golden Parachute payouts. (Harkinson).

Golden Parachutes have both supporters and opponents. Supporters cite that the use of golden parachutes is critical in helping companies hire and hold onto top talent executives especially when it comes to industries that are prone to mergers. Top talent is unlikely to choose a job that they have a high risk of losing due to a merger if they are not going to be compensated well for it. Golden parachutes are also cited in helping executives remain objective about mergers in a similar way. When a company receives a merger or acquisition offer that would result in the loss of jobs for top executives, if the executives will just lose their job and are not compensated for their loss, they are motivated to turn down the deal even if it is in the best interest of the company (Woodard). This is why supporters believe golden parachutes enable executives to do what is best for the company even if it results in the loss of their job.

Opponents are quick to point out that logically what the supporters claim makes sense; however, the data points them in a different direction. Data analysis shows that golden parachutes are almost too good at making CEOs and top executives consider mergers and acquisitions. It is proven that golden parachutes make companies more likely to accept acquisition offers, but when these companies are acquired it is at a lower premium in terms of share price compared to similar mergers in the industry. On average, a company with golden parachutes in place when acquired is at a premium 4.97 percentage points lower than acquisitions without golden parachutes in place. The 4.97 percentage points lower resulted in on average a reduction of $249 million in deal value (Falaschetti 3). This is a substantial amount of money the company is failing to gain because executives cannot think objectively about accepting an offer when they know that if they do, they will be walking away with millions of dollars.

The dramatic increase in the number of Golden Parachutes and the proven ill effects led to an increasing number of shareholder derivative suits aimed at challenging the validity of these executives' Golden Parachute packages. Many of these cases were successful and led to Congress taking action. Congress aimed to limit the size of future Golden Parachutes by placing specific provisions in the Deficit Reduction Act of 1984 (Bress 955).

These provisions added section 280G to the United States tax code. Under Section 280G, golden parachutes will be treated the same as all other compensation packages. However, as soon as parachute payments are considered excessive, they face a unique tax code. A golden parachute is considered excessive once the payout exceeds three times the employee's base salary—with the base salary being defined as the average annual compensation for the employee over the last five years. Once the parachute payment exceeds this threshold and is considered excessive it is treated differently. The amount that exceeds one times the base salary faces a 20% excise tax in addition to the ordinary income taxes the individual would have to pay. In addition to this, this amount over the one times the base salary threshold is also no longer tax deductible. As discussed earlier, US tax code allows for payments made by a corporation to its employees to be tax deductible. However section 280G prohibits the tax deductibility of excess payments that are a result of a change in control of the company to highly compensated individuals such as CEOs and other top executives. This prevents the company from being able to deduct Golden Parachutes from its taxes ("26 U.S. Code § 280G").



Visual representation of section 280G of the tax code. (*Aug Bar Graph).*

Impact on Corporation			Impact on Individual[1]	
Base Amount Equals	$500,000	(A)	Parachute Payments	$2,000,000
3 * Base Amount	$1,500,000	(B)	Base Amount	$500,000
Parachute Payments	$2,000,000	(C)	Excess Parachute Payments	$1,500,000
Excess of Safe Harbor	$500,000	(B - C)	Excise Tax %	20%
Corporation's Lost Deduction	$1,500,000	(C - A)	Excise Tax	$300,000
Corporation's Effective Tax Rate	40%			
Additional Cash Taxes	$600,000			

The above figure shows the tax effect on a income statement. ("Golden Parachute Payments Under Section 280G").

In 2011, Congress went further and passed the Dodd Frank Act. Within the Dodd Frank act section 951 mandates a shareholder advisory vote to approve golden parachute agreements and the disclosure of these deals to shareholders ("Say on Golden Parachutes"). This vote, although non-binding, was intended to allow shareholders to be able to voice their opinion on executive compensation before the deals were put in place. The non-binding nature of these deals failed to bring about true change as golden parachutes size has continued to increase.

The goal of this tax code and shareholder vote was to reduce the size of golden parachutes received by CEOs and top executives. By reducing the size of these payouts, it would reduce the negative influence that these large severance packages have over executives' decisions as well as reduce the unfair consequences to shareholders and company employees. It is proven that these measures by the government have failed to achieve this goal. Not only by the continued increase in the size of golden parachutes but also by companies reactions to these regulations.

Many companies, in the wake of the new excise tax imposed on parachute payments, put in place tax gross-ups for their CEOs. A tax-gross up is where a company increases the size of the golden parachute in order to cover the 20% excise tax that CEOs face on excessive parachutes. This gross-up comes at a high cost to the company because, “Such tax reimbursements by the employer are themselves parachute payments, and so are themselves subject to the excise, as well as to regular income and payroll taxes. If the corporation is generous and ‘grosses up’ the parachute payment so that the employee receives the full stated amount (net of all taxes), the cost to the company will approach $3.50 for every dollar received by the employee (Lev 3).” Although expensive, this practice is prevalent in the United States. In a 2009 study of the 500 largest U.S. corporations it was shown that 48% of CEOs are provided with full excise tax gross-ups with another 37% of CEOs receiving conditional gross-up payments if certain criteria are in place and 3% of CEOs receiving partial gross-up payments ("The Decline and Fall of the 280G”). With tax gross-ups effecting such a large portion of golden parachutes the effect of congress placing the tax is unfelt by CEOs and has no effect on the issue of fairness involved.

Due to the ineffectiveness of current policies on golden parachutes, it is clear that a new policy needs to be put in place that will truly be effective in combating this toxic business practice. Any policy needs to meet two criteria feasibility in being able to be put into place and effective in reducing the negative effects of this policy.

The first part of this policy is conquering gross-up payments. Following the 2008 recession, when the government put in place the Troubled Asset Relief Program it mandated that, “while any portion of a TARP recipient’s financial assistance from the U.S. Government remains outstanding, severance and CIC payments to certain executives and highly compensated employees are prohibited and commitments to pay tax gross-ups (both on CIC payments and perquisites) to certain executives and highly compensated employees are prohibited (Conway and Foster).” This policy showed that it is possible to prevent these payments in certain circumstances; however, this is when the government in effect has put money into a company. The government however has not invested money in all companies so it is unfair to have a law in place that prevents these companies from doing what they want with this money. Instead putting a policy in place that makes all gross-up decisions for parachute payments put up to a binding vote by shareholders would in effect be an equivalent to the TARP policy. Shareholders, in effect, have invested in these companies and because gross-up payments come at a significant cost to the company it is only fair to have their opinion taken into account when deciding whether gross-up payments should be allowed. This would not prevent a company from having gross-up payments if it wanted and needed them but would definitely reduce the high percentage of CEOs we see with gross-up agreements in place.

In effect that first part of the policy will bring down a majority of CEOs to feel the real effects of the tax, reducing the size of the golden parachute that they receive and, as a result, uncloud their judgment when it comes to merger and acquisition decisions. This brings the economy back in line with what the taxes purpose was intended to do in the 1980s. This however it is no longer the 1980s, the size of golden parachutes has grown to the average of near $30 million and many are tipping the scale of over $100 million. Although a 20% excise tax on a $100 million golden parachute will undoubtedly take out a large piece of payout. Does the difference of receiving a little more than $80 million compared to $100 million really change a CEOs perspective enough on considering mergers and acquisitions? It could be argued that it does not. The size of the payout after taxes is still so large that undoubtedly will affect a CEOs judgment. In addition to this, the size of CEO’s base pay has increased. From the around 1980 to now CEO compensation has increased by 997 percent. In 2014, the average CEO compensation for the largest U.S. firms was $16.3 million (Mishel and Davis). So in order for a golden parachute of the average CEO to even count as excessive it needs to be almost $50 million. Keeping in mind when the average worker loses their job due to a merger they are given two weeks pay, a number much less than $50 million seems excessive.

This frames the necessity of the second part of the policy to bring the tax code to meet current conditions. This change involves shifting the excessive parachute amount from three times base pay to one and a half times base pay. Then also increasing the tax rate from 20% to 30%. This policy still allows CEOs to walk away with a full year and a half of pay before facing the excise tax, which is still a substantial amount of money compared to what the average worker would receive. At the same time though, if the payout exceeds this new threshold the increased tax rate is aggressive enough that the size of the payout will be reduced substantially. This is in line with making sure that golden parachutes can still exist as a way to compensate CEOs for decreased job security but also make sure that CEOs decisions are not clouded by massive payouts if they lose their job.

The effect of this whole policy together will bring about a new wave of fairness in this area of executive compensation. Golden Parachutes got out of hand and needed to be brought back in. Congress attempted to do so with creating section 280G of the tax code and with shareholder votes on golden parachutes. These failed to make a substantial enough impact to reduce the negative consequences of large golden parachutes due to gross-up tax payments and the non-binding nature of the shareholder votes. This policy puts power back in the hands of shareholders by allowing them to have a binding say on whether or not a the company should finance gross-up tax payments due to the large cost they have on the firm. It also updates the tax code to work in the modern world to have the same effect it originally intended back in the

1980s. This returns back golden parachutes to a fair business practice that is no longer toxic to the companies that have them in place.

V. Policy #3: Mandate Binding Shareholder Vote on Executive Compensation

Passed by Congress in July of 2010 and implemented during proxy season of 2011--the time in which most companies hold their annual shareholder meeting--the Dodd-Frank Wall Street Reform and Consumer Protection Act moves to "improve accountability and transparency" in order to promote financial stability in the United States. Specifically, under subtitle E, *Accountability and Executive Compensation* amends the Securities and Exchange Act of 1934 to include a proxy vote for publicly traded companies (H.R. 4173).

Of the seven provisions to the Securities and Exchange Commission regarding executive compensation that the Dodd Frank Act proposed, five have been implemented (Implementing the Dodd Frank Act). Chair of the Securities and Exchange Commission, Mary Jo White, stated that with these provisions, the SEC is working toward an "increased transparency, better investor protections… and a stronger marketplace and financial future for all Americans." (Securities and Exchange Commission. Chair Mary Jo White). With these provisions, which build off of the 2006 SEC disclosure rules, the current system requires disclosure of the remuneration, or total pay package, of all directors as well as the Chief Executive Officer, the Chief Financial Officer and the three most highly paid officers. First, they are required to hold a frequency vote no less than every six years to decide whether the vote on the executive compensation policy will occur every one, two, or three years. Then, a compensation committee comprised of a few board members from the Board of Directors is tasked with writing the remuneration policy (H.R. 4173).

The Securities and Exchange Commission has adopted harsher disclosure regulations on executive remuneration policies including a clause in Section 951 that states that companies must disclose in the annual proxy statement meeting whether or not the vote is binding, though nearly all companies choose to have a non-binding vote. Section 951 also requires that companies disclose whether they have considered the results of Say-on-Pay votes in which shareholders formally vote to approve or disapprove of an executive remuneration package.

Section 952 (10(c)(2)) puts disclosure regulations on compensation consultants, also known as proxy advisers. Shareholders are often only given 30 days to read the proposed remuneration policy, which could be up to 70 or 80 pages. The compensation committees often hire proxy advisers to consult the committee to create a more concise proposal. Under this article of the Dodd Frank Act, companies must state whether these proxy advisers were engaged directly by the compensation committee or by another person to ensure that these concise reports were made ethically. They must also disclose the "nature and scope" of their assignment and the material elements of any instructions given to the consultants. Lastly, they must disclose the amount of money the consultant received for their service (Listing Standards).

The information regarding the remuneration policies themselves must come in three different forms on the annual proxy statement, which is available to the public through the SEC website: tabular, narrative, and the Compensation Disclosure and Analysis, or CD&A. The tabular and narrative sections offer basic information regarding the three preceding fiscal years and include salary, bonus remuneration, remuneration in equity terms, and that which is deferred (Orsagh). Below is an example of the Summary Compensation Table and Narrative from The American Express Company in 2009:

Summary Compensation Table (1)

Name and Principal Position	Year	Salary ($)	Bonus ($)(2)	Stock Awards ($)(3)	Option Awards ($)(3)	Non-Equity Incentive Plan Compensation ($)(4)	Change in Pension Value and Non-Qualified Deferred Compensation Earnings ($)(5)	All Other Compensation ($)(6)	Total ($)
K.I. Chenault	2009	$ 1,201,923	$ 5,125,000	$ 0	$ 3,985,637	$ 5,325,000	$ 780,929	$ 980,079	$ 17,398,568
Chairman and Chief	2008	$ 1,250,000	$ 0	$ 9,524,931	$ 9,775,850	$ 6,112,500	$ 640,711	$ 1,503,053	$ 28,807,046
Executive Officer	2007	$ 1,238,461	$ 6,000,000	$ 8,069,198	$ 14,299,950	$ 500,000	$ 2,671,958	$ 1,086,920	$ 33,866,487
E.P. Gilligan	2009	$ 862,019	$ 4,000,000	$ 1,999,990	$ 2,648,690	$ 1,612,500	$ 228,200	$ 1,371,487	$ 12,722,885
Vice Chairman	2008	$ 825,000	$ 3,500,000	$ 1,068,971	$ 1,584,600	$ 1,125,000	$ 67,388	$ 4,499,830	$ 12,670,789
	2007	$ 759,615	$ 3,206,000	$ 6,775,898	$ 8,034,000	$ 1,414,500	$ 446,178	$ 3,307,131	$ 23,943,322
S.J. Squeri	2009	$ 614,423	$ 2,500,000	$ 999,978	$ 3,762,926	$ 1,335,000	$ 121,082	$ 169,723	$ 9,503,131
Group President, Global Services and Chief Information Officer	2008	$ 600,000	$ 1,650,000	$ 499,996	$ 1,084,200	$ 675,000	$ 55,873	$ 203,424	$ 4,768,493
A.F. Kelly, Jr.	2009	$ 817,308	$ 4,000,000	$ 0	$ 1,036,263	$ 1,462,500	$ 217,808	$ 332,914	$ 7,866,792
President	2008	$ 850,000	$ 3,000,000	$ 1,124,979	$ 1,668,000	$ 1,125,000	$ 86,226	$ 409,374	$ 8,263,579
	2007	$ 771,154	$ 3,625,000	$ 7,268,597	$ 8,368,750	$ 1,414,500	$ 455,969	$ 388,972	$ 22,292,942
D.T. Henry	2009	$ 619,711	$ 2,100,000	$ 0	$ 797,125	$ 1,162,500	$ 72,072	$ 255,585	$ 5,006,994
Executive Vice President and Chief Financial Officer	2008	$ 625,000	$ 2,100,000	$ 718,968	$ 1,251,000	$ 300,000	$ 65,304	$ 280,737	$ 5,341,010
	2007	$ 411,192	$ 2,156,000	$ 397,169	$ 1,640,275	$ 460,000	$ 226,337	$ 206,914	$ 5,497,887

(1) Amounts shown are not reduced to reflect the NEO's elections, if any, to defer receipt of base salary, bonus or non-equity incentive plan compensation under our deferred compensation programs.

(2) The amounts in this column reflect AIA cash payments made for annual performance. The amount shown for Mr. Kelly for 2009 was paid in accordance with the terms of his separation agreement with the Company.

(3) The amounts in these columns reflect stock and option awards that were granted in 2009, 2008 and 2007. The amounts represent the aggregate grant date fair value of awards granted in each respective year computed in accordance with stock-based compensation accounting rules (FASB ASC Topic 718). See the Grants of Plan-Based Awards table on page 43 for further information on awards made in 2009. A discussion of the assumptions used in computing the award values may be found in Note 20 to our 2009 Consolidated Financial Statements on pages 111 to 113 of our 2009 Annual Report to Shareholders.

(4) For 2009, the amounts in this column reflect the cash payment made to the NEO in respect of (i) PG07-09 awards granted in 2007 (covering the 2007-2009 performance period) and (ii) the first half of PG09-10 awards granted in 2009 (covering the 2009 performance period), each of which was paid in February 2010.

(5) The amounts in this column reflect (a) the actuarial increase in the present value of the NEO's benefits under all defined benefit pension plans established by the Company and (b) the above-market portion of earnings on compensation deferred by the NEO under our nonqualified deferred compensation programs, which are shown below. The Company uses the Moody's "A" Rate, which is 6.14%, as our approximation for market-level earnings. However, for purposes of this table, SEC rules require that market-based earnings be considered to be no more than 5.35%. Accordingly, the table below shows the earnings attributed to the difference between the two rates.

The CD&A must include more applicable information, including the reasoning behind the tables and narratives offered in the public proxy statement. This includes all named elements of the company's executive officers as well as the objectives of the company's remuneration plan that the policy is designed to reward. Also included is each element of remuneration, why the company chose to pay each element, how the company determines each element, and how the policy and each element of the policy fits into the company's overall objectives and affect decisions regarding other elements of remuneration. The CD&A also requires a comprehensive summary of the policy from the previous fiscal year ("Disclosure of Remuneration"). The goal of the Compensation Disclosure and Analysis is to increase transparency to ensure that executives are not taking advantage of publicly traded companies. The following is the CD&A for The American Express Co. for 2009:

	Year ended December 31, 2009	Year ended December 31, 2008	Percentage Inc/(Dec)
Diluted earnings per share on a net income basis attributable to common shareholders (EPS)	$1.54	$2.32	(34)%
Return on average equity (ROE)	14.6%	22.3%	
Total revenues net of interest expense	$24.5 billion	$28.4 billion	(14)%
Worldwide billed business	$619.8 billion	$683.3 billion	(9)%
Worldwide total cards-in-force	87.9 million	92.4 million	(5)%
Worldwide cardmember lending – owned basis(1):			
- **Total loans**	$32.8 billion	$42.2 billion	(22)%
- **Net write-off rate**	8.5%	5.5%	
Worldwide cardmember lending – managed basis(1):			
- **Total loans**	$61.8 billion	$72.0 billion	(14)%
- **Net write-off rate**	8.4%	5.4%	

Review of 2009 Performance:

The year 2009 presented unprecedented challenges for U.S. businesses, given the speed and magnitude of the global economic downturn and the virtual collapse of the credit markets at the end of 2008. In early 2009, the CEO presented his objectives for the year, and the Compensation Committee approved shareholder, customer and employee goals that recognized the weakness and volatility of the economic environment, but also presented a high degree of difficulty. We believed these goals were important to position the Company well for the future. Our overarching objectives were to stay liquid, stay profitable and invest selectively for growth, all of which we met. We had $2.1 billion in income from continuing operations for the year, compared to $2.9 billion in 2008. Though disappointing in absolute terms, we stayed consistently profitable during a period when many card-issuing businesses suffered losses.

The Compensation Committee considered our results within the context of a number of benchmarks and achievements

- *As the best performer in the Dow Jones Industrial Average for 2009, we delivered a 125% total shareholder return (TSR) for the year, compared to 26% for the S&P 500 and 17% for the S&P Financials.*
- *We continued to make dividend payments at the same level as before the economic downturn.*

- *After participating in the U.S. Treasury's Capital Purchase Program, we were among the first companies to repay the equity investment, repurchasing the preferred shares and warrants we issued to the Treasury in June and July, respectively, and providing a 26% annualized return on investment to U.S. taxpayers.*

(American Express Company)

The adoption of Section 953(b) of the Dodd Frank Act by the SEC requires median annual salary of the company's employees be juxtaposed to the annual total compensation of the CEO (in a single total figure including salary, bonuses, pension rewards, etc.), but the current structure of a Say-on-Pay vote is a retrospective approval or disapproval to the board of directors, who often care more about pleasing the executive officers than what is in the best interest of the shareholders (Deutsch, Pagnattaro).

According to a Journal from Northwestern, the first proponents of an increased correlation between executive pay and performance were Professors Lucian Arye Bebchuk and Jesse M. Fried in their book, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation,* written in 2004. In chapter 15, the authors propose much of what was later implemented through the Dodd Frank Act of 2010 including tabular, monetary disclosure of compensation elements, as well as streamlining the disclosure requirements of compensation committees. Bebchuk and Fried argue that public opinions of executive compensation matter to the company because there is a correlation between the compensation and stock prices. The information disclosed should be understood by more than just a few experts to ensure that the salaries of top executives are relatively reasonable. (Bebchuk).

In 2008, Aflac became the first publicly traded company to allow shareholders to vote on the executive compensation package for CEO Daniel Amos. Shareholders overwhelmingly supported Amos's $11.96 million compensation package. Amos was in a good position, though, as his compensation reflected his performance. During his tenure, shares have increased by nearly 3,000% (Deutsch). Amos credits his company's transparency with investors to his investors' confidence in both his abilities and in the company as a whole (Corporate Secretary).

A problem with the current policies is that only 2% of shareholders vote down their executives' pay packages each year, meaning shareholders overwhelmingly support their executives' compensation. The only companies that disapprove of their shareholder votes are extreme cases, as shareholders view this as a black eye on the company. For example, Citigroup, with shares declining 90% over the last ten years voted against the pay package for their executive, Vikram Pandit (Gandel). The largest problem, though, are companies such as RadioShack Corp., Oracle Corp. and Nabors Industries, which all chose to ignore the say-on-pay vote and keep the original compensation package. Shareholders feel that companies such as RadioShack, though it has a similar compensation package to Staples, which passed its shareholder vote, does not work toward building the correlation between performance and pay. This type of pay for performance is very different than that discussed earlier in the paper in which companies pay tax-deductible bonuses dubbed performance based pay. The Chief Executive Officer of a company does very little to change the overall value of a company, but shareholders place value on the total shareholder return, or TSR, of a company when voting on the compensation policy and they have historically voted down only packages of failing companies (Chasan).

In order to give more power to the shareholders of a company, we are proposing that the existing shareholder vote should be a binding vote, meaning that it is the deciding factor on whether or not the pay is fair for each executive/director. This will ultimately amend the 2006 SEC Disclosure Regulations as well as Section 951 of the Dodd Frank Act. This policy changes the current policies in favor of standardization by taking away the option of holding a binding or non-binding vote. Shareholders ultimately own the company and every decision the executive makes could potentially change the value of their shares. Because there is such a small percentage of companies who decline the proposed compensation package, this policy will not change the entire system of shareholder votes, but instead, it will work to ensure that companies with failing executives and falling share prices do not unfairly pay their executives more than they deserve. The non-binding vote has led to executive pay that is increasing at a slower rate than the value of the shares of the company as well as an increase in the relationship between pay v. performance using the total shareholder return as an indicator of the executive's performance. This change in SEC policy hasn't necessarily made shareholders more apt to vote against policies. Instead, compensation committees make more frugal decisions knowing that shareholders can potentially disapprove of the package. By making this vote binding, it will prevent boards from ignoring shareholder decisions to ensure that the shareholders' views are not only taken into consideration, but are the deciding factor of an executive's compensation (Hodgson).

Non-binding votes fail to convey shareholder views when they are not aligned with the views of the Board of Directors. Requiring shareholders of publicly traded companies to hold a binding vote will ultimately give shareholders the ability to hold the Board of Directors responsible for bad decisions. According to Bruce Nolop, the former Chief Financial Officer of

E*TRADE Financial Corporation, often times investors do not trust Boards of Directors because some have "close ties" to the executive directors ("The Experts"). In some cases, The CEO chairs the Board leaving little room for investor opinion. A binding Say-on-Pay vote will take power away from the Board of Directors and the Compensation Committees and place more power in the hands of the shareholders.

The companies that decline the compensation of their highest paid employees and executives often do not have plans following the disapproval— or: compensation committees will move forward in paying their executives the same package that was declined by shareholders. This may scare some shareholders into approving an unfair compensation package because it reflects poorly on the company when there is a disconnect between shareholders and the Compensation Committee members/Board of Directors. To incentivize shareholders to vote based on the fairness of the compensation package, compensation committees should be required to keep the same package from the previous year until they can propose a new package that is approved by a secondary shareholder vote.

Finally, The Securities and Exchange Commission has not yet accepted Section 953(a) of the Dodd Frank Act. The acceptance of this section of the Dodd Frank Act by the SEC would mandate several ways to increase the correlation between pay and performance in CEO pay by mandating that proxy advisers include in their reports "information that shows the relationship between executive compensation actually paid and the financial performance of the issuer…" This amendment to the Securities Exchange Act of 1934 essentially calls for additional information as well as information that is already in the compensation report to be juxtaposed to allow shareholders to make a more informed decision. Similarly, this amendment also requires the tabular figuration of bonuses actually paid, not just those that have been accumulated over the years. The amendment proposes additional disclosure requirements between the Total Shareholder Return and the compensation paid in the previous five fiscal years and the same disclosure for that of similar publicly traded companies (Pay Versus Performance). This added information will allow shareholders understand whether the problem is a problem with the industry as a whole or rather a problem with the company's performance as they vote on the remuneration package. This disclosure requirement further solidifies the importance of transparency for the shareholders of publicly traded companies.

VI. Implementation:

It was the goal of the group to create a collection of policies that would cohesively resolve the issues surrounding CEO/Executive pay and taxation, specifically in regards to the idea of fairness. With the creation of these three policies, these issues would be addressed. However, in order to achieve this overarching goal, the policies would have to be enforced in today's business world. In order to accomplish this, these three policies would have to be proposed by a member (or members) of Congress and passed through the House of Representatives and the Senate. With this, it was imperative for the group to research the current laws that are enforced and previous legislation that may have been proposed, but was voted down (as discussed earlier in the paper). This was done in order to ensure that these policy proposals would not be repetitive and voted down when presented to Congress.

It was brought to the attention of the group when discussing the topic of CEO/Executive pay and taxation that there are numerous different types of corporations that exist in the United States of America. It was argued that it would not be fair, for example, if a policy was created that enforced a privately owned and operated business to abide by these laws. After much consideration, it was decided that these policies proposed would only affect public, publicly traded, and publicly held corporations. These corporations are all publicly owned through stock that is openly traded over the stock exchange. A Board of Directors typically operates public corporations, whereas private companies are led by the owner (or owners) and/or investors. A major factor that also helped make the decision to only apply this to public corporations was that public corporations are mandated to release financial information to the general public. In 1934, the "Securities Exchange Act" was passed that mandated the majority of companies registered with the Securities and Exchange Commission (SEC) to release quarterly and/or annually reports that disclose general information on finances ("Securities Exchange Act of 1964"). These companies registered with the SEC are publicly traded companies, not privately owned. Each time a report is made, the public company completes the Form 10-Q (the document that provides the overview of finances), which is then submitted to the SEC and released to the public ("Form 10-Q").

DJO Finance LLC
Unaudited Condensed Consolidated Statements of Operations
(In thousands)

	Three Months Ended December 31, 2010	Three Months Ended December 31, 2009	Year Ended December 31, 2010	Year Ended December 31, 2009
Net sales	$ 249,811	$ 257,175	$ 965,973	$ 946,126
Cost of sales (exclusive of amortization, see note 1)	89,204	91,524	345,270	338,719
Gross profit	160,607	165,651	620,703	607,407
Operating expenses:				
Selling, general and administrative	101,848	110,140	430,761	420,758
Research and development	4,969	5,959	21,892	23,540
Amortization of intangible assets	19,395	26,390	77,523	84,252
Impairment of assets held for sale	—	—	1,147	—
	126,212	142,489	531,323	528,550
Operating income	34,395	23,162	89,380	78,857
Other income (expense):				
Interest expense	(40,314)	(39,713)	(155,181)	(157,032)
Interest income	78	284	310	1,033
Loss on modification and extinguishment of debt	(18,702)	—	(19,798)	—
Other income (expense), net	(1,601)	3,064	859	6,073
	(60,539)	(36,365)	(173,810)	(149,926)
Loss from continuing operations before income taxes	(26,144)	(13,203)	(84,430)	(71,069)
Income tax benefit	15,697	1,777	33,680	21,678
Loss from continuing operations	(10,447)	(11,426)	(50,750)	(49,391)
Income (loss) from discontinued operations, net of tax	—	115	—	(319)
Net loss	(10,447)	(11,311)	(50,750)	(49,710)
Net income attributable to noncontrolling interests	(30)	(355)	(857)	(723)
Net loss attributable to DJO Finance LLC	$ (10,477)	$ (11,666)	$ (51,607)	$ (50,433)

Note 1 — Cost of sales is exclusive of amortization of intangible assets of $9,132 and $36,343 for the three months and year ended December 31, 2010, and $9,385 and $37,884 for the three months and year ended December 31, 2009, respectively.

Figure One ("DJO Finance LLC")

An example of what financial information a common Form 10-Q would provide can be seen above in Figure One. With this already in place, it was considered fair to regulate these public companies further so that they provide both accurate and explicable financial reports to the general public.

With the conclusion of this paper, the next step of the group would be to present this proposal to a Think Tank that has heavy lobbying power, where it would be researched and funded further to garner both the attention and the support of politicians. Think Tanks are organizations of individuals that collaborate on different subjects in order to either propose a new solution or offer recommendations on certain matters. There are numerous different types of Think Tanks; they can be university-run, industry-based, for profit, not for profit, etc. They can range in focus, some being independent while others advocate in favor of conservative or libertarian policies (Greenwood). Below in Figure Two, a layout of the structure of Think Tanks can be found with how the conversation and research flows.

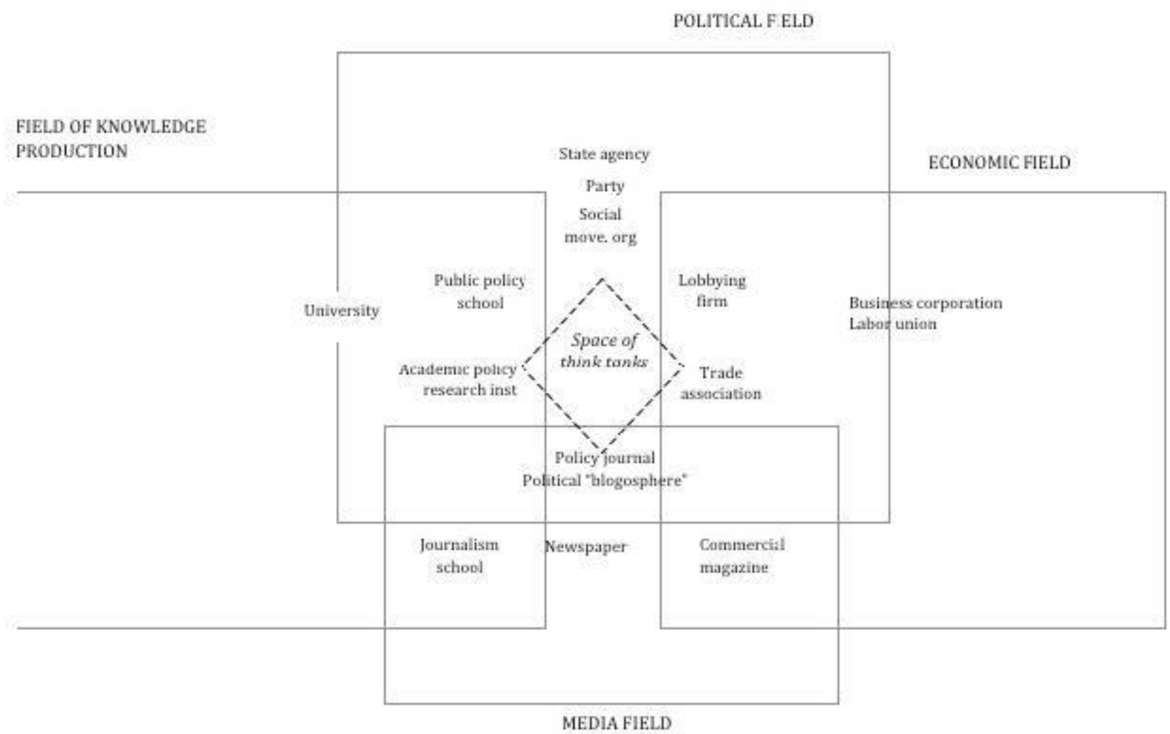


Figure 2 (“Think Tank Definitions”)

Think Tanks have gained popularity in both the United States and Europe. In a study completed by the University of Pennsylvania, researchers found that of all the Think Tanks in the world, the top three were the Brookings Institution (based in the United States of America), Chatham House of the United Kingdom, and the Carnegie Endowment for International Peace (also found in the United States) ("Public Policy Research Think Tanks 2011"). Think Tanks, like the Brookings Institution, have proven to be effective in offering new proposals for pieces of legislation for Congress. This specific Think Tank would be an excellent example of an organization that the CEO/Executive pay and taxation group would present this policy to in hopes to garner their support and funding.

The Brookings Institution is a nonprofit organization based in Washington DC and focuses on public policy. Their mission is as follows ("About Brookings"):

"…To conduct high-quality, independent research and, based on that research, to provide innovative, practical recommendations that advance three broad goals:

- Strengthen American democracy;
- Foster the economic and social welfare, security and opportunity of all Americans; and
- Secure a more open, safe, prosperous and cooperative international system."

The CEO/Executive Pay and Taxation proposal the group is proposing adheres to the goals that the Brooking Institution follows. It would strengthen democracy through the increased transparency and influence of shareholders, enhance the economic welfare of Americans across the nation, and create a fair system that aligns with countries around the world. This policy would be a beneficial contribution to the research and advocacy the Brookings Institution was founded upon.

When choosing which policies to use for the final proposal, the group wanted to ensure that rather than creating three new ideas individually, it would be best to create three policies that would collaboratively achieve the overarching goal of fairness pertaining to CEO and Executive pay and taxation. With that, each policy was written to focus on a different side of the issue. The first policy proposal is removing a loophole that is found in a law regarding taxing executive pay. The focus is centered on eliminating this loophole so the lost tax revenue of seven billion dollars could be regained. The second policy of restricting the use of golden parachutes would be the modification or amendment of a law that passed through Congress previously. It is aimed to lower the excessive payout threshold and discourage companies from promising executives large payouts in the event of a merger or take-over. Last, the third proposal is the creation of a new policy. This law is necessary for not only increasing CEO and executive pay transparency, but also placing more power into the voting hands of the shareholders. Collectively the three policies embody a solution that dissipates the unfairness that is found with CEO and executive pay and taxation.

In reality, having these policies brought to the floor of Congress and passed would be extremely difficult, but through the research and avenues of implementation the group is suggesting, having this proposal considered by legislators is not out of the realm of possibility. Similar policies like these have been proposed and rejected (such as Senate Bill 1476 Stop Subsidizing Multimillion Dollar Corporate Bonuses Act), but taking in the comments from those, the group was able to observe and create new policies that should be widely accepted. By taking this proposal to a Think Tank such as the Brooklyn Institution, garnering both the attention and support of politicians should be favorable.

VII. Conclusion:

The issue of fairness pertaining to CEO and Executive pay and taxation is clear. Beginning with the fact that in 2014 a CEO on average made 296 times that of its average worker and the top 1% of Americans owned 23% of the nation's wealth, the need for a diminish in the wage gap could not come at a greater time. In the past few years, a small number of Congressmen have attempted to address a portion of the concerns surrounding Section 162 (m) of the United States Tax Code and the loopholes that currently exist, but there has yet to be a policy found successful or worth legislating. That is why this group created the following three policies to address this problem: eliminate the performance based tax loophole, increase restrictions on the use of golden parachutes, and mandate a binding vote on executive compensation. Between the three, these policies will rectify current tax law and resolve the unfair circumstances that are ongoing.

Regarding performance-based pay, the group has composed a policy with two facets. First, rather than limit the maximum tax deductibility of executive pay to $1 million, the group proposes a revision to Section 162(m) of the Internal Revenue Code to limit the tax deductibility of executive pay to a maximum of 50x that of the average worker's salary. Meaning, a company can deduct its CEO's salary as an expense from their taxable net income up to a value of 50x that of his average employee, while the excess of that would be taxed. For instance, if a company paid its average employee $20,000, the CEO would only be eligible to receive $1 million in tax-deductible income. This way, companies aren't forced to reduce their CEO's pay to avoid taxes, they can raise the average wage instead. The second piece of the solution is to remove the tax deductibility of performance-based pay. As discussed earlier, there is no indication that increased compensation is an effective motivator for executive performance and the practice of pay for performance has drastically increased the amount of compensation executives receive, exacerbating the wealth gap. Therefore, the group suggests this toxic business practice be eradicated from law by making performance pay fully taxable to the company.

The second policy first places a binding shareholder vote on determining whether or not a company should gross up a CEO's excessive golden parachute tax, with the goal of having companies stop paying this tax for their CEOs. This will result in the burden of the tax actually being placed on the CEO and will reduce the size of the payout they receive. By allowing the tax to actually have an effect on decreasing the size of the payout, it will uncloud the CEO's judgment. Since the original tax was put in place in the 1980's, the average size of golden parachutes has increased to over thirty million dollars with many over a hundred million dollars. This means even when companies do not gross up the CEOs tax, the size of the golden parachutes is still too large for CEOs to think objectively about merger and acquisition offers. The second part of this policy updates the tax code to decrease the excessive golden parachute amount from 3x base pay to 1.5x base pay and raise the tax from 20% to 30%. Updating the tax code in combination with a binding shareholder vote on gross-up payments allows golden parachutes to still exist as a way to attract top CEO talent to firms, but now be a safe and ultimately more fair business practice.

The third and final policy the group proposed strives to increase shareholder power through mandating a binding say-on-pay vote and increasing the amount of information that is provided in the annual proxy statement that is issued to the shareholders prior to the vote. In previous policies geared toward increasing the transparency and accountability of the shareholders implemented by the Securities and Exchange Commission, the results have been positive. Since 2010, the rate at which executive pay is increasing is now increasing at a slower rate. This policy though goes above what previous policies have done to regulate SEC requirements and instead reflects the system in the United Kingdom, which experiences a much lesser discrepancy between CEO and median worker salary.

With the implementation of these three policies, no individual policy would apply to private companies, but rather publicly held companies that are openly traded over the stock exchange amongst shareholders. By doing this, the group is able to remain in line with the overarching goal of fairness. At the completion of this paper, it would be taken to a Think Tank (specifically The Brooklyn Institution if possible) where the policy would be researched and explored further. Once finalized, the organization would have its leadership lobby and advocate to legislators in favor of the policy proposal. Hopefully following this, the policy would be supported by politicians. These politicians would then write legislation and present it to Congress, where it would eventually be passed into law.

Unfairness surrounding CEO and Executive compensation is not a matter that can be resolved simply. This is a problem that has grown exponentially over the past few decades and has become accepted by the population due to its overwhelming power. Although it may be an issue that individuals in the corporate world have grown accustomed to, that does not merit it the right to go unresolved. That is why this group chose this large topic; it was an issue recognized to be not only unfair, but also destructive to the United States financial welfare amongst citizens. The group does not expect these three policies to answer all of the problems surrounding the topic, but it is believed to address the larger scale complications that do exist. Between eliminating the tax loophole, restricting golden parachutes, and creating a binding say-on-pay vote, fairness will no longer be a leading concern when considering the compensations and taxing of CEOS and Executives.

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