# Revenue Consequences of 162(m)

Congress enacted section 162(m) in the Internal Revenue Code as part of the Omnibus Budget Reconciliation Act of 1993, P.L. 103-66. This legislation capped a public company's corporate income tax deduction at $1 million per year for amounts paid to each of its top five executives. This $1 million limit includes income from salary, bonuses, stock grants, and other compensation, but it does not include income that relates to performance pay such as a non-equity incentive plan, stock options, stock appreciation rights, pensions, and deferred compensation (if deferred until after retirement).[1] The purpose of the law was to rein in executive pay by imposing a higher effective tax rate on salaries above the $1 million threshold. In effect, this limit imposed over a 60% federal surtax on salaries above $1 million. In order for an executive to receive an additional dollar above the cap in take home pay, the firm would have to generate an additional $2.56 in revenue because of corporate and incomes taxes. Given this high tax, few expected anyone to exceed it as executives and firm compensation committees have a strong incentive to ensure that payments plans avoid this penalty for the fiduciary interest of their shareholders. ACA and other policies further promoted this policy with an even lower limit of $500,000.

This is the first analysis using taxpayer data to explore this phenomenon nearly twenty-five years since the enactment of this policy. Surprisingly, some firms pay salaries in excess of this limit. If taxed at the highest rate, this provision netted $1.1 billion in 2013. This is orders of magnitude larger than the Joint Committee on Taxation's estimate of $67 million a year in 1993.[2] Based on current trends, this figure will likely continue to increase, driven largely by more firms willing to pay salaries above the limit. The increasing degree to which firms exceeds the cap raises questions about the ability of compensation committees to operate in the fiduciary interest of their shareholders. If compensation committees acted in the best interest of their shareholders then the Treasury would not potentially be receiving billions in tax revenue from this provision. The findings here suggest a costly mistake or a very expensive guarantee cost; regardless, both are troubling to shareholders as more than 25% of publically traded corporations exceeded the limit in 2013.

Researchers found that total executive pay decisions have been relatively insulated from this policy intervention (Rose & Wolfram 2002; Ferris & Wallace 2009). [3] Speaking anonymously to BusinessWeek for fear of losing their positions, members of compensation committees for four of the nation's largest corporations said that 162(m) is merely a nuisance that has not stopped them from paying executives whatever they consider fair.[4] Frydman and Saks (2010) estimated that the average three highest paid executives at top firms received total pay packages of $7.63 million from 2000 to 2005 with the average CEO receiving $9.20 million. Those executives in the top ten percent of companies received packages averaging $16.9 million.[5] This policy has though, unintentionally, established $1 million as the de facto executive salary. Evidence suggest that firms paying base salaries in excess of $1 million lowered salaries to $1 million (Perry and Zenner 2001) and other

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[1] Balsam, S. "Taxes and Executive Compensation." *Economic Policy Institute* (August 14, 2012), http://www.epi.org/publication/taxes-executive-compensation/.

[2] "Estimated Budget Effects of the Revenue Provisions of H.R. 2264 (The Omnibus Budget Reconciliation Act of 1993)" *Joint Committee on Taxation* (August 4, 1993), http://www.jct.gov/x-11-93.pdf.

[3] Rose, N. and Wolfram, C. "Regulating Executive Pay: Using the Tax Code to Influence Chief Executive Officer Compensation." *Journal of Labor Economics* Vol. 20 No S2 April 2002): S138-S175. Ferris, K. and Wallace, J. "IRC Section 162(m) and the law of Unintended Consequences." *Advances in Accounting* Vol 25, Is 2 (December 2009): 147-155.

[4] Epstein, Keith and Javers, Eamon. "How Bill Clinton Helped Boost CEO Pay." Bloomberg (November 27, 2006) http://www.bloomberg.com/news/articles/2006-11-26/how-bill-clinton-helped-boost-ceo-pay

[5] Frydman, Carola, and Raven E. Saks. "Executive compensation: A new view from a long-term perspective, 1936–2005." *Review of Financial Studies* (2010).

firms raised salaries below $1 million to exactly $1 million (Rose and Wolfram 2002).[6] Many firms also modified bonus plans by replacing discretionary plans with overly generous formulas (Murphy and Oyer 2005; Balsam & Ryan 2007). This transition usually takes place after hiring new executives as it presents a better opportunity to redesign the executive pay package (Balsam & Ryan 2007).[7] Thus, most executive pay comes from performance pay, but as mentioned, performance pay can essentially be structured as a guarantee. This analysis adds to the literature because it explores the phenomenon of firms exceeding the deduction limit.

This analysis looked at nine years of corporate tax returns filled between 2005 and 2013 for publicly traded firms. The data in this analysis comes from the Internal Revenue Service (IRS) Statistics of Income division's (SOI) Corporation file. Every year, SOI randomly samples corporate income tax returns (Form 1120), edits numerous variables for consistency and accuracy, and uses them to publish aggregate statistics. Although this tax provision went into effect in 1993, this analysis begins in 2005 because changes in reporting requirements created a vehicle to see which firms exceeded the limit and by how much. Corporations now have to report on Schedule M-3 the total compensation that feel under the 162(m) provision for the top five executive officers. [8] This broke out for the first time the total deductible and nondeductible compensation for these executives. This analysis dropped any firm not publically traded or that did not exceed the limit. Because of data unavailability, the analysis cannot occur for years before 2005.

Total nondeductible executive compensation has been steadily increasing as more firms exceeded the limit as seen in Figure 1. Between 2005 and 2013, publically traded corporations paid top executives over $22.5 billion in non-deductible compensation, as seen in Table 1. This analysis weighted all the figures in Table 1 to mimic the population. The second column lists the number of corporations that exceeded the limit in that year. For publically traded corporations, 27% of all firms exceeded the limit in 2013. Perhaps firm accidently exceeded the limit one year but corrected it afterward. The data, however, does not indicate this correction. Of the firms exceeding the limit at some point, 75% of firms exceeded the limit for more than one year. For these firms, 18% exceeded it every year that they were in this analysis. The third column list the average amount firms exceeded this limit. If a firm had taxable income, column four lists the average percent of their taxable income that they forwent because they exceeded the deduction. The last column then list total nondeductible compensation by all the firms in this analysis.

During this period, the total compensation exceeding this limit increased from $2 billion to $3 billion and the number of firms exceeding the limit increased by 63% from 725 to 1,185. Yet the average amount that a firm exceeded the limit and the percent of taxable income forgone have been stagnant. Thus, driving this growth then has been the willingness of more firms to ignore this deduction limit. If taxed at the highest corporate tax bracket of 35%, then this provision, at most, raised $1.1 billion in 2013 and $7.9 billion cumulatively between 2005 and 2013. Most of the firms exceeding the limit are some of the largest corporate firms as defined by having at least a billion dollars in asset size. Asset size is determined by adding together gross receipts, total dividends, gross rents, interest, gross royalties, absolute capital gain net income, and absolute net gain or (loss). The industries with the most firms exceeding the limit did not change significantly between 2005 and 2013. The top five industries include Service, Metal and Machinery Manufacturing, Wholesale and Retail Trade,

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[6] Perry, T. and Zenner, M. "Pay For Performance? Government Regulation and the Structure of Compensation Contracts." Journal for Financial Economics vol. 62, issue 3 (December 2001): 453-488.

[7] Balsam, S. & Ryan, D. "Limiting Executive Compensation: The Case of CEOs Hired after the Imposition of 162(m)." *Journal of Accounting, Auditing, & Finance* vol. 22 no. 4 (October 2007). Oyer, P. and Schaefer, S. "Why Do Some Firms Give Stock Options to all Employees?: An Empirical Examination of Alternative Theories." *Journal of Financial Economics* vol 76, iss. 1 (April 2005): 99-112.

[8] Boynton, C., DeFilippes, C. and Legel, E. "A First Look at 2005 Schedule M-3 Corporate Reporting." *Tax Notes* (November 3, 2008) http://www.irs.gov/pub/irs-utl/schm-32005firstlookboynton-defilippes-legel11_03_08.pdf.

Information, and Finance & Management of Companies as seen in Table 2. These five industries consistently accounted for 61% of firms exceeding the limit and 45% of the total nondeductible executive compensation.

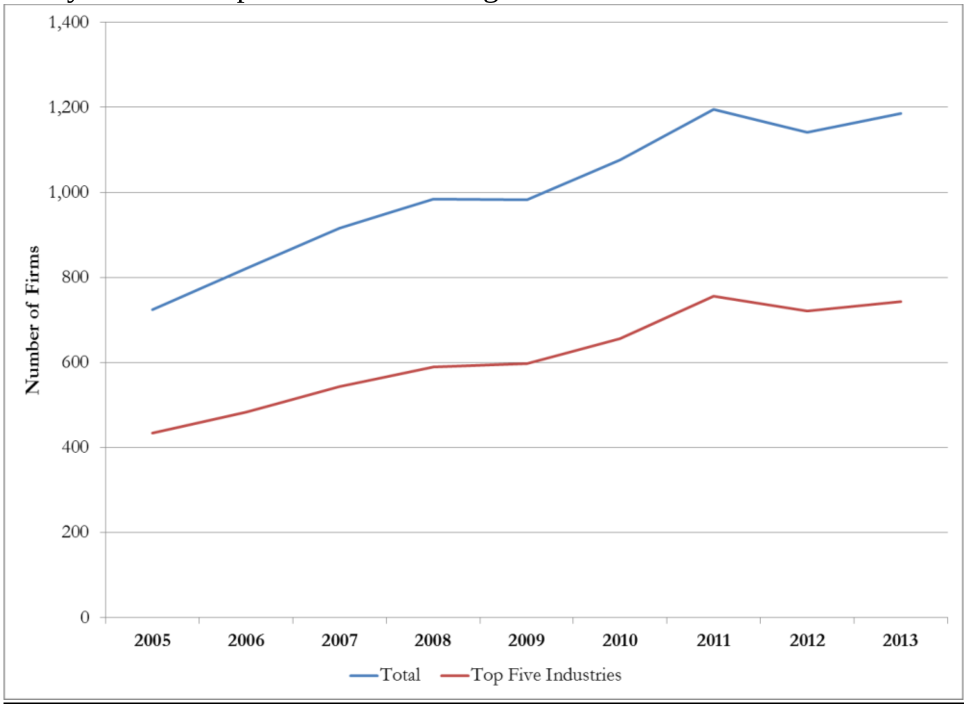
As part of the Troubled Asset Relief Program (TARP) legislation in 2008, Congress created a lower deduction limit at $500,000 with no performance pay exemptions for any entity receiving TARP funds. Congress also enacted similar requirements for any health insurer beginning in 2013 as part of the Patient Protection and Affordable Care Act (ACA). These new restrictions appear to have been ineffective in reducing executive compensation. Most firms quickly repaid the TARP funds. Therefore, the TARP specific limits did not apply to them.[9] The number of firms classified as in the Insurance Carriers and Related Activities Industry category, which includes Health Insurers, exceeding the limit actually increased from 15 to 22 from 2011 to 2013, although this is still less than the high of 32 in 2009. While these few firms seem to be exceeding the limit to a greater degree because of the lower threshold established in the ACA, they only represents 1% of the total amount of non-deductible compensation that firms have forgone.

Over time, more firms have exceeded the limit on executive compensation, no doubt in part because the $1 million threshold has not been adjusted for nominal (inflation) or real growth. If adjusted for inflation, the threshold in 2013 dollar's would be $1.8 million.[10] But this is only part of the reason, since simply adjusting the original Joint Committee on Taxation estimate for inflation explains only about a tenth of the growth in the estimate between the mid-1990s and 2013. Driving this growth then has been the apparent increasing number of firms willing to exceed the cap, even adjusting for inflation. Based on this trend, the tax revenue collected from firms willing to forgo this deduction will likely continue to increase.

The findings here raise questions about firms mistakenly exceeding this limit and paying high taxes because of it or their willingness to pay high taxes for compensation guarantees even though firms can already essentially guarantee performance pay packages. Using taxpayer data for the first time, these findings raise an important concern regarding the ability of executive compensation committees to act in the fiduciary interest of their clients. This analysis found that between 2005 and 2013, public corporations paid top executives in excess of $22.5 billion in nondeductible compensation. Furthermore, more than 25% of all publically traded corporations exceeded the limit between 2005 and 2013 with 75% of those exceeding it doing so for multiple years. Given these findings, shareholders need to ask if these pay packages are worth their high cost.

[9] "TARP Tracker from November 2008 to February 2016." *U.S. Department of the Treasury*. https://www.treasury.gov/initiatives/financial-stability/reports/Pages/TARP-Tracker.aspx
[10] I adjusted these figures for inflation using the Bureau of Labor Statistics Inflation Calculator: http://data.bls.gov/cgi-bin/cpicalc.pl.

**Figure 1:**
Publically Traded Corporations Exceeding the Deduction Limit from 2005 to 2013




Notes: This figure shows the weighted number of estimated publically traded corporations that pay their top five executives salaries in excess of the salary deduction limit between 2005 and 2013. It increased by 63% from 725 to 1,185 during this time. This estimate is computed using the Internal Revenue Service (IRS) Statistics of Income division's (SOI) Corporation file. The industry classifications are the standard industry classifications for the Office of Tax Analysis in the U.S. Department of the Treasury. The top five industries include Service, Metal and Machinery Manufacturing, Wholesale and Retail Trade, Information, and Finance & Management of Companies. These five industries consistently accounted for 61% of firms exceeding the limit and 45% of the total nondeductible executive compensation.

**Table 1:**
Summary Statistics for Publically Traded Corporations Exceeding
Executive Deduction Limit from 2005 to 2013

| **Years** | **Number of Firms** | **Average Firm Nondeductible Executive Compensation (in millions)** | **Average Percent of Taxable Income Forgone** | **Total Nondeductible Executive Compensation (in millions)** |
|---|---|---|---|---|
| 2005 | 725 | $2.8 | 1.88% | $2,047 |
| 2006 | 821 | $2.5 | 1.55% | $2,013 |
| 2007 | 916 | $2.3 | 1.54% | $2,143 |
| 2008 | 984 | $2.3 | 1.40% | $2,250 |
| 2009 | 982 | $2.2 | 1.36% | $2,144 |
| 2010 | 1,076 | $2.6 | 1.68% | $2,817 |
| 2011 | 1,107 | $2.8 | 1.72% | $3,040 |
| 2012 | 1,141 | $2.6 | 1.85% | $2,983 |
| 2013 | 1,185 | $2.6 | 1.83% | $3,057 |
| | | | | *Total $22,493* |

Notes: The second column lists the weighted number of corporations that exceeded the limit in that year. The third column list the average amount firms exceeded this limit. If a firm had taxable income, column four lists the average percent of their taxable income that they forwent because they exceeded the deduction. The last column then list total nondeductible compensation by all the firms in this analysis. This table shows that driving the growth of compensation over this limit has been the willingness of more firms to ignore this deduction limit. Total compensation exceeding this limit increased from $2 billion to $3 billion and the number of firms exceeding the limit increased by 63% from 725 to 1,185. Yet the average amount that a firm exceeded the limit and the percent of taxable income forgone have been stagnant.

**Table 2:**
Summary Statistics for Publically Traded Corporations Exceeding Executive Deduction Limit for Industries, 2013

| Industry | Number of Firms | Average Firm Nondeductible Executive Compensation (in millions) | Average Percent of Taxable Income Forgone | Total Nondeductible Executive Compensation (in millions) |
|---|---|---|---|---|
| Agriculture, Forestry, Fishing and Hunting | N/A | N/A | N/A | N/A |
| Mining | 64 | $3.2 | 2.2% | $201.9 |
| Utilities | 47 | $2.7 | 0.3% | $124.6 |
| Construction | 17 | $1.1 | 1.0% | $18.8 |
| Non-Durable Manufacturing | 71 | $1.8 | 1.0% | $127.8 |
| Fossil Fuels | 12 | $4.2 | 7.1% | $50.4 |
| Chemical Manufacturing | 70 | $3.0 | 2.0% | $207.9 |
| Computer and Electronic Manufacturing | 93 | $2.5 | 4.5% | $232.2 |
| Metal and Machinery Manufacturing | 172 | $2.4 | 1.7% | $418.7 |
| Wholesale and Retail Trade | 160 | $2.4 | 1.2% | $391.2 |
| Transportation and Warehousing | 26 | $3.1 | 1.6% | $79.5 |
| Information | 119 | $4.8 | 1.9% | $565.9 |
| Finance, Management of Companies | 111 | $2.4 | 2.0% | $266.4 |
| Insurance Carriers and Related Activities | 22 | $1.8 | 2.3% | $38.9 |
| Rental and Leasing Services | 13 | $1.7 | 0.8% | $22.3 |
| Real Estate | N/A | N/A | N/A | N/A |
| Service | 182 | $1.6 | 1.3% | $291.3 |

Notes: The second column lists the weighted number of corporations that exceeded the limit in that year. The third column list the average amount firms exceeded this limit. If a firm had taxable income, column four lists the average percent of their taxable income that they forwent because they exceeded the deduction. The last column then list total nondeductible compensation by all the firms in this analysis. This table shows that driving the growth of compensation over this limit has been the willingness of more firms to ignore this deduction limit. Information for industries with fewer than five firms is not provided.