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TAX'S TRIVIALITY AS A PAY-REFORMING DEVICE

ANDREW C.W. LUND*

I. INTRODUCTION

PERIODICALLY, the federal government has altered the tax rules relating to executive compensation. Sometimes these changes have been driven by pure tax policy concerns.¹ At other times, the changes in tax policy were motivated by a desire to correct market failure in the executive pay-setting mechanism. That is, tax intervention was driven largely by intrafirm concerns—usually that managers were extracting rents to the detriment of shareholders and, possibly, other corporate constituencies.

In all events, these attempts to use tax policy to influence executive compensation have been routinely decried. More particularly, the interventions driven by corporate governance concerns, most prominently Section 162(m)'s limitation on the deductibility of compensation costs and the Sections 280G/4999 deduction limitation for, and excise tax on, parachute payments, have been widely panned.² The complaints about these innovations are varied but tend to coalesce around an accusation that the intervention is either ineffective, distortive, or both.

This Article is devoted to explaining the ineffectiveness of tax policy as a response to compensation market failure. In short, market forces seem to overwhelm whatever prodding the tax code tries to effect. Part II describes Sections 162(m) and 280G/4999 and briefly shows how they have been largely ineffective in changing compensation practices. Why have these kinds of tax interventions—the ones that try to correct the pay-setting process between executives and boards—failed? Undoubtedly, there is a plausible public choice explanation centered on political motivations and competence. Part III describes this explanation. Parts IV and V, however, suggest that public choice explanations for the failure of governance-driven tax interventions are actually too generous and might lead us to be

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1. See, e.g., Gregg D. Polsky, *Fixing Section 409A: Legislative and Administrative Options*, 57 VILL. L. REV. 635 (2012).

2. See, e.g., Kevin J. Murphy, *The Politics of Pay: A Legislative History of Executive Compensation*, in RESEARCH HANDBOOK ON EXECUTIVE PAY (Randall S. Thomas & Jennifer Hill eds., forthcoming 2012) (manuscript at 2). (“The emerging conclusion is that attempts to regulate CEO pay [including tax interventions] have been mostly unblemished by success.”); Joy Sabino Mullane, *Incidence and Accidents: Regulation of Executive Compensation Through the Tax Code*, 13 LEWIS & CLARK L. REV. 485, 519–26 (2009); Gregg D. Polsky, *Controlling Executive Compensation Through the Tax Code*, 64 WASH. & LEE. L. REV. 877, 884 n.36 (2007); Ryan Miske, Note, *Can't Cap Corporate Greed: Unintended Consequences of Trying to Control Executive Compensation Through the Tax Code*, 88 MINN. L. REV. 1673, 1674–75 (2004).

too sanguine about the possibility of “better” executive compensation tax rules in the future. Part IV lays out the basic case that tax interventions, as observed to this point, have trivial effects on board decision making regarding executive pay. Simply put, the tax penalties pale in comparison with boards’ perceptions of the performance-related gains to be realized by either hiring the best (even if most expensive) executive or properly incentivizing any executive with a particular mix of compensation elements. This intuition has been borne out by empirical studies showing the extremely modest effects of tax interventions on pay practices.

Part V develops the triviality thesis by recognizing that tax has little effect on pay practices because the penalties are modest. Were penalties more significant, they might not be overwhelmed by the considerations described in Part IV. But Part V offers reasons to believe that tax penalties in this context will almost never be implemented so as to be so heavy-handed. Most importantly, many policymakers and almost all scholars believe that there is substantial heterogeneity among firms regarding optimal compensation practices, leading to a reluctance to adopt tax penalties with real bite that feel closer to mandatory rules.

II. SECTIONS 162(M) AND 280G/4999 IN ACTION

Section 162(m) of the Code was enacted in 1993. It operates by limiting the business-expense deduction available to public firms for amounts paid to “top five” executives.³ Specifically, a firm may not deduct amounts paid to such officers in excess of \$1 million annually. The deduction limitation may be avoided by qualifying the compensation that exceeds \$1 million, usually by paying under a plan that (i) provides for payments based on objective performance goals, (ii) is approved by an independent compensation committee of the board, and (iii) is approved by a majority of the shareholders after disclosure of the material terms of the compensation arrangement.⁴

Thus, Section 162(m) evinces a preference for contingent forms of pay such as performance bonuses, at- or out-of-the-money stock options, and stock awards that vest upon achievement of performance targets. That preference is based on a significant theoretical literature produced by legal academics and financial economists describing the importance of performance-based compensation. This standard account observes that performance-based pay works to align incentives and mitigate agency costs

3. Top five executives include the CEO and the four next most highly compensated officers. *See* TREAS. Reg. § 1.162-27(c)(2) (2012). The definition of “officer” is determined in accordance with the rules for executive compensation disclosure under Regulation S-K. *Id.* In effect, then, the covered employees for purposes of § 162(m) are the same as those for whom compensation disclosure is mandated unless the firm’s chief financial officer is not among its five highest paid officers. In that case, disclosure would capture that officer but not the fifth most highly paid officer, while § 162(m) would cover in the opposite fashion.

4. I.R.C. § 162(m)(4)(C) (2006).

otherwise borne by public firms when they are run by non-owner executives.⁵ Section 162(m)'s additional requirements of independent director and shareholder approval respond to the additional concern that nominally performance-based pay might not truly be "performance-based" because of the clubby nature of the board/executive relationship.⁶ Working together, these requirements for receiving a full deduction were intended to produce optimal intrafirm governance outcomes, heightening executive incentives to maximize profits and reducing their ability to extract rents.⁷

As most of those who have studied the issue concede,⁸ Section 162(m) has been largely unsuccessful in achieving its governance goals. This failure may be driven by forces beyond the legislative design,⁹ but nevertheless the design itself is problematic. Its preference for completely performance-contingent pay may often lead to suboptimal contracts. First, it encourages workarounds through the use of deferred compensation arrangements such that the actual taxable/deductible event occurs once the executive in question is no longer a covered officer.¹⁰ Second, the design of Section 162(m) advantages options vis-a-vis restricted stock. At-the-money or out-of-the-money options introduce convexity into compensation arrangements thereby increasing risk-taking incentives,¹¹ but it is less clear that this heightened convexity will provide optimal incentives in a significant set of cases.¹² Finally, the definition of the performance-based qualification allows firms to deduct expenses even in cases where the compensation is hardly performance-based.¹³

5. See, e.g., Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, HARV. BUS. REV., May–June 1990, at 138. For more on the history of the pay-for-performance movement, see Andrew C.W. Lund & Gregg D. Polsky, *The Diminishing Returns of Incentive Pay in Executive Compensation Contracts*, 87 NOTRE DAME L. REV. 677 (2011).

6. For the formal account of this view, see LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 49–51 (2004).

7. See Mullane, *supra* note 2, at 519–26.

8. For a pessimistic view of section 162(m)'s success, see *supra* note 2.

9. For a discussion of other influences, see *infra* notes 23–39 and accompanying text.

10. See Polsky, *supra* note 2, at 893–96. But see Frederick Tung, *Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation*, 105 NW. U. L. REV. 1205, 1207–08 (2011) (suggesting that bank executives' inside debt holdings may be beneficial).

11. See, e.g., John E. Core, Wayne R. Guay, & David F. Larcker, *Executive Equity Compensation and Incentives: A Survey*, 9 ECON. POL'Y REV. Apr. 2003, at 27, 33.

12. See *id.* at 33; see also Lucian Bebchuk & Jesse M. Fried, *Paying for Long-Term Performance*, 158 U. PA. L. REV. 1915, 1940–41 (2010).

13. See, e.g., Mullane, *supra* note 2, at 523–25 ("As an initial matter, satisfying the performance-based requirements is not challenging. Treasury regulations provide that a performance goal does not need to be 'based upon an increase or positive result under a business criterion and could include, for example, maintaining the status quo or limiting economic losses.' Furthermore, once the thresh-

To add insult to injury, it may be that Section 162(m) had the unintended consequence of pushing pay higher at firms where executives had not previously earned \$1 million.¹⁴ The legislative announcement that salaries in excess of \$1 million were excessive in Congress's view seems to have implied that any salary below \$1 million was reasonable. On this account, Section 162(m) was able to set a norm that quickly ratcheted up executive salaries, particularly given the Lake Wobegon world of pay-setting and pay-setting's transparency due to heightened disclosure rules.¹⁵

The problems with Section 162(m)'s deduction-limitation regime are more significant in magnitude but not especially different in kind from that other attempt to influence corporate governance through the tax code—the restrictions on golden parachute payments to executives at acquired firms. Similar to Section 162(m), Section 280G operates to limit a firm's deduction for compensation paid. Under Section 280G, the compensation in question involves payments made to highly compensated individuals that are contingent upon a change in control in the firm.¹⁶ If the contingent payment is greater than three times the individual's five-year average take home pay prior to the change in control, then it qualifies as a "parachute payment" and the excess of that amount over the average take home pay is a non-deductible expense for the firm. Section 4999 hits the other side of the payor-payee equation and imposes an excise tax on the executive receiving the excess parachute payment.¹⁷

Like Section 162(m), Sections 280G and 4999 have hardly met resounding success. In the realm of unintended consequences, Section 280G seems to have driven an increase in the adoption of change-in-control agreements¹⁸ and normalized a "2.999X" standard for change-in-control payments.¹⁹ By leading to both the proliferation and normalization of these payments around a "~3X" multiple, Sections 280G and 4999 argua-

old requirements have been met, there is no limit to the amount of performance-based compensation that can be deducted." (footnote omitted)).

14. See Steven Balsam & David Ryan, *Limiting Executive Compensation: The Case of CEOs Hired After the Imposition of 162(m)*, 22(4) J. ACCT., AUDITING & FIN. 599, 617–18 (2007); see generally David G. Harris & Jane R. Livingstone, *Federal Tax Legislation as an Implicit Contracting Cost Benchmark: The Definition of Excessive Executive Compensation*, 77 ACCT. REV. 997 (2002).

15. See, e.g., Scott Schaefer & Rachel M. Hayes, *CEO Pay and the Lake Wobegon Effect*, 94 J. FIN. ECON. 280 (2009) (discussing previous suggestions of phenomenon and developing game-theoretic model for it).

16. I.R.C. § 280G(2)(c)(2) (2006) (defining "highly-compensated individual" as one "who is (or would be if the individual were an employee) a member of the group consisting of the highest paid 1 percent of the employees of the corporation or, if less, the highest paid 250 employees of the corporation").

17. See *id.* § 4999 (imposing "tax equal to 20 percent of the amount of [an excess parachute payment]").

18. See Murphy, *supra* note 2, at 14 n.20 (quoting studies by Richard Alpern and Gail McGowan).

19. See Miske, *supra* note 2, at 1679–84 ("By codifying a salary multiple, § 280G created a floor on parachute benefits that directors and executives could point to as a congressionally sanctioned standard of reasonableness.").

bly increased compensation costs at firms.²⁰ Just as in the case of 162(m) (heightened convexity), the propriety of the governance ends purported to be achieved by Sections 280G/4999 are a matter of some dispute, with many suggesting that high golden parachute payments increase shareholder value by making executives more open to takeovers.²¹ Finally (and most importantly for the purposes of this Article), easy workarounds were developed to blunt the effect of the tax rule,²² in particular, tax gross-ups.

III. THE STANDARD CRITIQUE OF TAXING EXECUTIVE COMPENSATION FOR CORPORATE GOVERNANCE ENDS

Why does it seem so hard for Congress to properly tax executive compensation so as to improve intrafirm governance outcomes? Perhaps most obviously, there is a simple political economy story that calls into question the likely effectiveness of executive compensation intervention.²³ Omari Simmons, for one, has previously noted the peculiar political characteristics of executive compensation debates.²⁴ In essence, information about the efficacy of various corporate reforms is in short supply and executive compensation is one of the most salient issues to the voting public. As a result, legislators may deviate from efficient policy outcomes more than they would otherwise in order to satisfy their constituents' desire for action, even if only the symbolic sort.²⁵

The special nature of executive compensation thus subjects federal tax intervention to an even more serious critique than is generally leveled at congressional action in the corporate governance arena. For instance, Roberta Romano famously called the Sarbanes-Oxley Act's mandates "quack corporate governance."²⁶ As she described it, the law's quack-ish

20. Kevin Murphy also contends that Section 280G encouraged firms to shorten vesting periods in equity plans to avoid a greater charge in case calculations under Sections 280G/4999 needed to be made to account for the gain to executives by the accelerated vesting caused by the change in control. *See* Murphy, *supra* note 2, at 15.

21. *See, e.g.*, Mullane, *supra* note 2, at 513 n.109.

22. *See id.* at 517–19.

23. *See, e.g.*, Murphy, *supra* note 2, at 2 ("A larger part of the problem is that the regulation is often mis-intended. The regulations are inherently political and driven by political agendas . . .").

24. *See* Omari Scott Simmons, *Taking the Blue Pill: The Imponderable Impact of Executive Compensation Reform*, 62 SMU L. REV. 299, 332 (2009).

25. *See id.* at 329 ("Knee-jerk responses to populist outrage may not qualify as earnestly pursuing the public interest, especially when symbolic measures are used to mitigate outrage from less informed constituencies. Given the credence characteristics of corporate reform, federal lawmakers have greater capability and incentives to camouflage their rent seeking."); *see also id.* at 332 ("The credence characteristics of executive compensation reform provide self-interested lawmakers with greater flexibility to choose a diagnosis of the executive compensation problem that is the most politically profitable. As a result, lawmaker diagnosis and recommended treatment regimens are at times inconsistent and muddled.")

26. Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L. J. 1521, 1521 (2005).

governance provisions were largely the product of policy entrepreneurs who found themselves in a position to drive the legislative process because legislators were ignorant and uninterested in corporate governance provisions and the fact of the crisis post-Enron provided a push to accomplish *something*.²⁷ Romano rejects the notion that those governance mandates represented merely symbolic politics,²⁸ but notes that the law's enhanced criminal penalties for corporate actors may have been just that.²⁹ This dismal account of the production of business law reform corresponds with other post-crisis moments where regulation of questionable effect was enacted to slake the public thirst for accountability.³⁰

More recently, Stephen Bainbridge has leveled a similar charge of quackery at the Dodd-Frank legislation passed in response to the financial crisis of 2008.³¹ Again, a crisis pressured legislators to do *something*, leading them to ready-made solutions provided by policy entrepreneurs.³² Again, some of the actions may have been merely symbolic.³³ And, again, it is far from clear that the corporate governance rules adopted under Dodd-Frank are justified by any evidence or plausible theory of firm behavior.³⁴ Bainbridge sums up the characteristics of corporate governance quackery:

1. It is a bubble law, enacted in response to a major negative economic event.
2. It is enacted in a crisis environment.
3. It was a response to a populist backlash against corporations and/or markets.
4. It is adopted at the federal rather than state level.
5. It transfers power from the states to the federal government.
6. Interest groups that are strong at the federal level but weak at the Delaware level support it.
7. Typically, it is not a novel proposal, but rather a long-standing agenda item of some powerful interest group.
8. The empirical evidence cited in support of the proposal is, at best, mixed and often shows the proposal to be unwise.³⁵

Not all of these characteristics would seem to be required before leveling the charge of ineffective and possibly destructive political pandering at a

27. *See id.* at 1568–85.

28. *See id.* at 1585–87.

29. *See id.*

30. *See generally* STUART BANNER, *ANGLO-AMERICAN SECURITIES REGULATION: CULTURAL AND POLITICAL ROOTS, 1690–1860* (1998).

31. Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779, 1797–1819 (2011).

32. *Id.* at 1786–87.

33. *Id.* at 1783, 1796.

34. *Id.* at 1818–19.

35. *Id.* at 1796.

regulatory measure. In fact, the cause of the crisis (1), anti-federalism markers (4-6), and the measure's history (7) are arguably unimportant for doing so.

On Bainbridge's terms, then, we should be concerned with post-crisis legislation that manifests a popular backlash against business without any evidence in favor of doing so. Along these lines, the danger of "quackery" is probably stronger in matters of executive compensation than in governance matters generally. It is perhaps useful to note that a large chunk of Dodd-Frank's governance provisions were executive compensation provisions.³⁶ Executive compensation is hugely salient to the press and voters.³⁷ As one homely example, consider the recent conflagration over a report demonstrating that some public companies paid more to their CEOs than they did in federal income taxes.³⁸ The urge to do something in response to populist outrage is likely to be among the strongest a legislator faces and, accordingly, we should not expect much good to come from compensation-related legislation.

I have no quibble with the characterization of tax measures directed at reining in executive compensation as something akin to "quackery." It may very well be an apt one and the tale of political economy alone might help explain much of the trouble with tax intervention in executive compensation that aims to achieve ends unrelated to corporate governance.³⁹ But, in the remaining sections of this Part, I wish to emphasize that the case against tax incursions into executive compensation is much more damning than implied by the traditional complaints from political economy.

IV. THE TRIVIALITY OF EXECUTIVE COMPENSATION TAX RULES

Most importantly, taxing executive compensation for governance purposes will have trivial governance effects under almost every plausible regime.⁴⁰ Boards, whether facing a competitive market for executive talent, beholden to powerful executives, or both, will not usually negotiate differently in response to a new tax regime. Because tax considerations are generally overwhelmed by all of the other pressures found in the compensation-setting process, we should expect firms to agree to bear any

36. One prominent law firm summarized ten "significant" corporate governance provisions, five of which were related to executive compensation. See Scott L. Landau et al., *Dodd-Frank Act Reforms Executive Compensation and Corporate Governance for All Public Companies*, CLIENT ALERT (Pillsbury Winthrop Shaw Pittman LLP, New York, N.Y.), July 15, 2010, available at http://www.pillsburylaw.com/siteFiles/Publications/CorpSec_CorpSec-Tech_ECB_Alert6_07-15-2010.pdf.

37. See Andrew C.W. Lund, *Compensation as Signaling*, 64 FLA. L. REV. 591, 613-618; see also Simmons, *supra* note 24, at 322-23.

38. See, e.g., David Kocieniewski, *Where Pay For Chiefs Outstrips U.S. Taxes*, N.Y. TIMES, Aug. 31, 2011, at B1.

39. See Polsky *supra* note 1, at 643-51.

40. For a discussion questioning the limits of political plausibility, see *supra* notes 23-39.

costs imposed by the tax rules unless some non-tax reason arises to cause them not to do so.⁴¹

At the most basic level, when tax law becomes a species of corporate law it becomes subject to the “triviality” attribution leveled by Bernie Black over twenty years ago.⁴² Black’s claim was that state corporate law would have literally no effect on governance outcomes in most cases. That law would either be (i) market mimicking in that it simply duplicated what the market would have otherwise required, (ii) avoidable via easy workarounds, (iii) changeable over time via political or litigation pressure, or (iv) unimportant.⁴³ The claim for tax law’s triviality made here is less robust, though it implies some version of the “workaround” and “unimportance” strands of Black’s framework.

Admittedly, tax rules that increase the compensation burden will have some effect on the firm as the new tax will be a cost that must be paid.⁴⁴ That cost may qualify the tax rule as “important” or “unimportant” relative to firm value, but this is beside the point. The charge of triviality in this instance simply means that the tax incursions in executive compensation will have no effect on the way in which firms pay managers.⁴⁵ Put another way, tax is trivial with respect to the sphere of activity Congress intends to impact when it uses sticks to prod firms.

Why are compensation patterns so insensitive to tax rules? Consider the baseline assumption animating most tax interventions that massive market failure exists in the compensation bargaining process at public companies. Boards that might negotiate aggressively with managers to arrive at an optimal pay package face incentive and relational problems in doing so. Most famously, Bebchuk, Fried, and Walker suggested that managerial power over directors—of both hard and soft varieties—characterized much of executive compensation contracting.⁴⁶ There is more to their powerful argument, but, essentially, it conceives of executives being able to extract rents during pay negotiations with relatively obsequious boards constrained only by “outrage costs” in the form of shareholder revolt, bad press, a governmental response, or some combination thereof.⁴⁷

41. Alternatively, tax penalties could become so extraordinary that there might be a constraint on firms’ abilities to absorb them without the capital markets exacting some sort of price. For a discussion rebutting this proposition and suggesting that there is good reason to think that tax penalties will not reach such levels, see *infra* notes 89–93 and accompanying text.

42. See Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 544–46 (1990).

43. *Id.* at 551–52.

44. See *id.* at 563 (discussing costs imposed by 280G and 4999).

45. If the burden is high relative to firm value, the tax may shift valuations as to make private firms more attractive to capital markets than the public firms subject to the tax rules.

46. BEBCHUK & FRIED, *supra* note 6, at 72–73; Lucian Arye Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 783–95 (2002).

47. See, e.g., Bebchuk, Fried & Walker, *supra* note 46 at 786.

The managerial power thesis has been criticized both for its inability to explain why certain arrangements exist and, more often, for its implicit or explicit implications for reform.⁴⁸ Regardless of the merits of that debate, one can certainly conclude that some level of distortive managerial power exists such that there is *some* slack at *some* firms. Boards may not be completely beholden to CEOs and they may often operate in good faith to arrive at the optimal pay package, all things considered. Still, they face informational problems⁴⁹ and cognitive biases that may lead, for example, to an overvaluation of the impact of managerial talent.⁵⁰ Thus, whether managerial power of the kind Bebchuk, Fried, and Walker suggest is strong or weak, we should expect to see some level of excess compensation packages for public company managers.⁵¹ Given a background level of managerial power, tax rules, it is thought, might help in moving executive compensation contracts back towards optimality.⁵² Hence, Section 162(m) attempts to push firms towards more performance-sensitive arrangements on the assumption that powerful managers are able to systematically distort outcomes toward less performance sensitive arrangements.⁵³

But precisely because of this baseline assumption regarding the manager's bargaining position, the tax penalty has a very serious strike against it in changing firm behavior. First, assume the strong managerial power view suggested by Bebchuk, Fried, and Walker. Recall under this theory

48. See Lund & Polsky, *supra* note 5, at 684 n.14.

49. See John E. Core, Wayne R. Guay & Randall S. Thomas, *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142, 1146–47 (2005) (noting that even boards negotiating pay packages in good faith are reliant on others for relevant information).

50. See RAKESH KHURANA, *SEARCHING FOR A CORPORATE SAVIOR: THE IRRATIONAL QUEST FOR CHARISMATIC CEOs* 190–91 (2004).

51. See Core, Guay & Thomas, *supra* note 49, at 1142 (noting that executive compensation contracts are almost sure to be second-best efficient).

52. See, e.g., Mullane, *supra* note 2, at 522 (“The Senate Finance Committee believed ‘excessive compensation [would] be reduced if the deduction for compensation (other than performance-based compensation) paid to the top executives of publicly held corporations [was] limited.’ Section 162(m) thus appears to have two aims: (1) to curtail levels of executive pay, and (2) to encourage a stronger connection between pay and performance.” (footnote omitted)); see also David I. Walker, *A Tax Response to the Executive Pay Problem* 7-8 (Boston Univ. Sch. of Law, Working Paper No. 11-50, 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1944115 (offering a tax solution to corporate governance failure attributable to managerial power).

53. There are reasons, however, to think that managers might actually prefer performance sensitive pay designs. First, managers may be overconfident and discount the possibility of firm failure under their watch. See Tung-Hsiao Yang & Don M. Chance, *The Effect of Executive Confidence, Ability and Private Beliefs on the Valuation of Executive Stock Options* 7–8 (March 10, 2011) (unpublished manuscript), available at <http://ssrn.com/abstract=1783034>. Second, managers may recognize that contingent pay is generally less salient in the eyes of shareholders and the business press and therefore subject to a more relaxed outrage constraint. See Lund & Polsky, *supra* note 5, at 721–23.

executives hold too much sway over pay-setting boards and, as a result, observed pay practices tend to be both too rich and too insensitive to performance.⁵⁴ It is hard to see how the incentives provided by Section 162(m) could do much work in this world.⁵⁵ A truly powerful executive might simply prevent the restructuring of his or her pay into qualifying, performance-based types. In that case, the firm would lose the deduction, thereby harming shareholders. Even if Section 162(m) disclosure provided a focal point that activated outrage, Section 162(m)'s requirement that any pay over \$1 million be performance-based would simply shift the mode of rent extraction away from salary increases to performance-based compensation increases, deferred compensation increases, or the camouflaging of performance-insensitive pay (assuming imperfect tax regulations permit it). Most importantly, managers with power over their boards, forced to take on risky pay, should simply demand more of it to compensate themselves for the increased risk.⁵⁶ Even when the risky pay has a significantly higher expected value than the less risky kind, the risky pay is less salient to shareholders and the business press (and obviously tax regulators) precisely because of the risk and the sense that an executive must have earned pay that is performance-based.⁵⁷

Section 162(m) does require that performance-based pay be approved by an independent board and shareholders which might mitigate such rent extraction. But the kind of board independence required by Section 162(m) is not materially more restrictive than compensation committee independence requirements in place at the time of its adoption relevant to avoiding short-swing profit liability under securities laws.⁵⁸ If managerial power over boards was a problem then or now, Section 162(m)'s safeguard of independent board approval seems to do very little.⁵⁹ Moreover, even unhappy shareholders are at a disadvantage when faced with approving a performance-based pay plan in that a veto would potentially cause the firm to forego any deduction.⁶⁰

If one adopts a less strong view of managerial power, tax intervention might again be thought appropriate to remedy residual rent accumulation

54. See Bebchuk, Fried & Walker, *supra* note 46, at 784.

55. Bebchuk and Fried say as much themselves. See BEBCHUK & FRIED, *supra* note 6, at 72–73.

56. See, e.g., Jensen & Murphy, *supra* note 5 at 147 (“Creating better incentives for CEOs almost necessarily means increasing the financial risk CEOs face.”).

57. See Lund & Polsky, *supra* note 5, at 718–23.

58. Rule 16b-3 excludes from short-swing profit liability officers' exercise of an option and subsequent sale of the acquired security provided the options were awarded by “non-employee” directors. Section 162(m)'s independence requirements do not contain certain exclusions for related-party transactions that the short-swing profit rules do, though there is no indication that the Treasury intended to draw this distinction when the regulations for Section 162(m) were promulgated.

59. And if managerial power is not much of a problem, then the distortive capacity of a rule like Section 162(m) would overwhelm its benefits.

60. See BEBCHUK & FRIED, *supra* note 6, at 49–51.

due to some other sort of market failure afflicting the pay-setting process, e.g., informational problems or systematic overvaluation of executives' labor. Even then, however, the market forces pushing towards excess pay should overwhelm all but the most penal tax rules. Consider the likely possibility that excessive pay is at least partially caused by distortions in the CEO labor market such that prospective managers have overly inflated negotiating power.⁶¹ In order for tax to correct the problem, one has to have an account of how a relatively small tax penalty (and one that is generally restricted to a lost deduction for the company such that it is externalized to shareholders) is able to overcome that pressure. Tax cannot make that power go away and, given its economic effect, should barely be expected to blunt it.

As a result, the governance changes encouraged by the tax rules are largely ignored or distorted. Moreover, whether the resulting tax penalties are nominally incurred by the firm (Sections 162(m) and 280G) or the manager (Section 4999), the firm will usually bear the cost of those penalties because of the negotiating dynamic. To the extent that this model breaks down at all, it does so not because of the tax rules, but rather because of an exogenous market constraint.⁶² Unless tax is somehow focusing market attention on some objectionable pay practice and therefore activating an otherwise dormant constraint, it does almost nothing other than increase firm expenses.

Finally, if strong or weak managerial power does not exist or does not lead to market failure in compensation setting, the case for governance-driven tax intervention becomes obviously weaker.⁶³ A number of financial economists have offered reasons for thinking that the executive compensation market is relatively efficient. For example, Kevin Murphy and Ján Zábajník posit that the nature of the CEO position has changed in recent years such that managerial ability, which is transferrable across firms, now trumps firm-specific knowledge in importance.⁶⁴ As a result, we should expect to see an increase in the price of talented managers' labor.⁶⁵ If true, there would be no bargaining problem capable of amelioration through regulation, as heightened levels of executive compensation

61. See KHURANA, *supra* note 50, at 26.

62. For an example of how market constraints may shift the burden sharing of tax penalties, see *infra* note 87 and accompanying text.

63. There may, of course, be broader tax goals that such intervention might promote, though measures targeted at executive compensation seem likely to be an inefficient means of achieving those goals.

64. See Kevin J. Murphy & Ján Zábajník, *Managerial Capital and the Market for CEOs 4* (Queen's Univ. Dep't of Econ., Working Paper No. 1110, Apr. 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=984376.

65. See *id.* at 24–30. Of course, the fact that firms are increasingly likely to hire outside CEOs may be linked to a less rational explanation. See KHURANA, *supra* note 50, at 47 (noting market failures in the CEO labor market). If true, the higher wages commanded by CEOs would not represent an efficient outcome and tax intervention might be appropriate.

simply reflect the increased competition for managerial talent.⁶⁶ Any tax penalties would impose needless costs on firms. But, to be clear, we should expect those costs to be unrelated to incentive reduction or retention problems as firms should simply choose to take the tax penalty and hold firm on the optimal compensation contract to avoid more damaging managerial departures or other behavioral defections.⁶⁷ The distortion instead would occur in the capital markets as firm's expected cash flows would have to be discounted by the tax.⁶⁸

Experience with tax interventions bear out these predictions of triviality. Consider first, Section 162(m) and the push for increasingly performance-sensitive pay. To be sure, executive pay is riskier and more contingent on firm performance than it once was. Brian Hall and Jeffrey Liebman found that the median elasticity of CEO pay relative to firm performance doubled between 1980 and 1994, driven by both an overall increase in payouts and a shift away from fixed pay to contingent pay.⁶⁹ The trend has continued over the last decade plus, but it is interesting to note that the Hall and Liebman study covered a period almost entirely before Section 162(m)'s enactment meaning that at least the early part of the drive towards more performance-sensitive pay had little to do with tax consequences.

In another study, Hall and Liebman analyzed tax rate changes during the 1980s and 90s and found little effect of those changes on pay components.⁷⁰ Rather, the increased emphasis on stock options during that period was apparently driven by market forces beyond tax rules.⁷¹ With respect to Section 162(m) in particular, Hall and Liebman find evidence of a "minor substitution of performance-related pay for salary" after the enactment of the rule.⁷² Yet even this small substitution effect is impossi-

66. For another defense of the efficiency of the compensation-setting market, see Core, Guay & Thomas, *supra* note 49, at 1165–69 (noting that U.S. firms had higher returns than lower-paying international peers during period in which U.S. pay increased). Core et al. offer a more robust attack on Bebchuk and Fried's managerial power thesis on the grounds that contracting costs make arm's-length bargaining impossible and permit a process that involves some level of managerial power to be optimal at a given firm. *Id.* at 1160–65. Note, however, that this would not preclude regulatory intervention aimed at balancing out the distortions created by those contracting costs. See *id.* at 1182.

67. There should be a level of tax that would be high enough to completely offset the gains achieved by the optimal compensation contract such that firms would begin to deviate. But see *infra* notes 89–93 for reasons to expect that level to remain unmet.

68. See Walker, *supra* note 52, at 9.

69. Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q.J. ECON. 653, 655 (1998).

70. See Brian J. Hall & Jeffrey B. Liebman, *The Taxation of Executive Compensation*, in 14 TAX POLICY AND THE ECONOMY 1, 1 (James M. Poterba ed., 2000).

71. See *id.* at 3 ("Instead, changes in corporate governance, especially in the role of large institutional investors, appear to have provided the main impetus for the increase in stock-based pay.").

72. *Id.* at 36.

ble to tease out from the increased market pressure to pay in performance-based pay during this period.⁷³ The smallness of the observed substitution seems to indicate that tax played a very small role, if any.

Similarly, Nancy Rose and Catherine Wolfram found little evidence that Section 162(m) had an impact on salary growth rates.⁷⁴ Like Hall and Liebman, they looked to differences between “affected”—meaning firms with predicted compensation near Section 162(m)’s \$1 million cap—and “unaffected” firms’ changes in salary growth around Section 162(m) enactment. In the majority of their tests, they found no significant evidence of differences between such firms.⁷⁵ In fact, they concluded by noting the fragility of the Section 162(m) effects and suggesting that Section 162(m) has apparently had little impact on compensation practices.⁷⁶

How do these post hoc findings manifest themselves in firms’ pay decisions? First, a large number of firms simply forego deductions because of Section 162(m) rather than limit an executive’s salary to \$1 million. Steven Balsam and Jennifer Yin studied a number of “firm years” between 1994 and 1998 and found that in almost 38% of them the firm forfeited deductions by failing to comply with Section 162(m).⁷⁷ That percentage consisted of one or more firm years at almost exactly half of the sample firms.⁷⁸ About a third of the forfeitures were caused by salaries in excess of \$1 million and a minority of the forfeiting firms qualified their short-term bonus plans as performance-based.⁷⁹ Firms consistently opted for compensation flexibility over tax savings.⁸⁰

More recently, many firms have shifted away from stock options toward restricted stock. Restricted stock is essentially a heavily discounted

73. *See id.* at 24.

74. *See* Nancy L. Rose & Catherine Wolfram, *Regulating Executive Pay: Using the Tax Code to Influence CEO Compensation*, 20 J. LAB. ECON. 138, 166 (2002).

75. *See id.* They did find higher variation among “affected” firms that did not adopt plans to qualify pay as performance-based. *Id.* It is hard to interpret this datum, however, because plan qualification has no tax effect on the salary payments that are the fluctuating dependent variable.

76. *See id.* (“This conclusion is consistent with the views expressed by many compensation consultants and corporate directors we have consulted. . . . Our results suggest that corporate pay may be more insulated from this type of blunt political pressure than its from the more direct pressure brought to bear at the individual firm level by stakeholder groups or through the regulatory process.” (citations omitted)). *But see* Balsam & Ryan, *supra* note 14, at 600 (arguing that stickiness of pay practices for incumbent CEOs at time of Section 162(m)’s adoption account for lack of evidence for its effect).

77. *See* Steven Balsam & Qin Jennifer Yin, *Explaining Firm Willingness to Forfeit Tax Deductions Under Internal Revenue Code Section 162(m): The Million-Dollar Cap*, 24(4) J. ACCT. & PUB. POL’Y 300, 314 (2005).

78. *See id.*

79. *See id.* at 315.

80. *See also* Austin Reitenga, Steve Buchheit, Qin Jennifer Yin & Terry Baker, *CEO Bonus Pay, Tax Policy, and Earnings Management*, 24 J. AMER. TAXATION ASS’N, 2002, at 1, 2–3.

option.⁸¹ Because of that discount, restricted stock cannot count as qualified compensation for Section 162(m) purposes unless its vesting is conditioned on separate performance goals.⁸² Yet in 2006, restricted stock grants became the largest component of pay packages for senior executives at large public companies, pushing stock options to second place.⁸³ This change was driven by any number of reasons, but occurred in spite of the plainly negative tax considerations.⁸⁴

There is less direct evidence of the effect of Sections 280G and 4999 on change in control severance packages, but perhaps that is because it was immediately apparent that they would have a very small one. Firms were willing to work around the tax rules, forfeiting deductions and grossing executives up for the cost of the excise tax. This happened despite the fact that the resulting tax impact was significantly higher than it would have been had the executive borne the brunt of it.⁸⁵ Of late, gross-ups have become more limited.⁸⁶ But nothing changed in the tax regime to bring about this shift. Rather, institutional investors and other activists have begun to push back against Section 4999 gross-ups after twenty years of their proliferation. The reduction in gross-ups has correlated directly with the adoption of anti-gross-up guidelines by the most significant proxy advisor in 2009.⁸⁷ What we see, then, is the clash between market forces—a competitive market for managerial talent on the one hand and the effect of increasing shareholder activism on the other—not anything remotely driven by tax rules.⁸⁸

81. Specifically, it is an option to purchase company stock with an exercise price of \$0.

82. Performance-vesting restricted stock (performance shares) makes up only a fraction of restricted stock awards. See David I. Walker, *Evolving Executive Equity Compensation and the Limits of Optimal Contracting*, 64 *VAND. L. REV.* 611, 632 (2011) (finding time-vested restricted stock accounted for 45% of restricted stock awards).

83. See *id.* at 633.

84. See *id.* at 634–39.

85. See, e.g., Mullane, *supra* note 2, at 517–18.

86. See Jennifer S. Conway & Nicole F. Foster, *Golden Parachute Tax Gross-Ups: Weathering the Storm?*, *BLOOMBERG L. REPS.* (Cravath, Swaine & Moore LLP, New York, N.Y.), available at http://www.cravath.com/files/Uploads/Documents/Publications/3251629_1.PDF.

87. See RISKMETRICS GROUP, 2009 U.S. PROXY VOTING GUIDELINES SUMMARY 38 (2008), available at <http://www.usfunds.com/media/files/pdfs/compliancepolicies/RMG2009SummaryGuidelinesUnitedStates.pdf>. Interestingly, proxy advisors are apparently sanguine about the deductions lost by firms that have shifted toward restricted shares. See, e.g., ISS, 2011 U.S. PROXY VOTING GUIDELINES SUMMARY 37–42 (2011), available at <http://www.issgovernance.com/files/ISS2011USPolicySummaryGuidelines20110127.pdf> (expressing no opinion about the choice to use options or restricted stock nor any view about the different tax results implicated thereby).

88. Moreover, a relatively simple workaround for anti-gross-up rules would be to simply top up the initial severance payment so that, even after the 10% excise tax, the net payment to the executive is the same. It is unclear whether this strategy has been utilized in a post-gross-up environment.

V. THE MODESTY OF TAX RESPONSES

Much of the triviality analysis in the preceding section can be attributed to the magnitude of the penalty imposed by the tax intervention. For example, imagine if Section 162(m) not only limited the ability of a firm to claim a deduction but also imposed a significant surtax on a firm that paid over \$1 million to a top five executive in non-performance-based pay. In that case, we might very well expect firms to alter their behavior in response to tax incentives. The tipping point in this context may be higher or lower than someone might predict, but the basic point should be uncontroversial: there is a point at which tax costs could outweigh the costs of deviating from market-based pay outcomes. As a result, much of the argument for triviality implies that the costs imposed by tax intervention are relatively small, at least in comparison with those deviation costs.

Why are the tax burdens so low? One way to conceive of tax rules with more significant penalties is as coercive regulation. An extreme tax is effectively a mandatory rule. But despite all of the hand wringing about excessive executive pay, few critics have endorsed some sort of coercive regulation limiting executive pay. For instance, David Walker, one of the main proponents of the managerial power thesis described above, has expressed concerns about distortions occasioned by coercive compensation regulation, e.g., pay caps.⁸⁹ The concern about distortive effects brought on by mandatory rules presupposes an important point: firm heterogeneity with regard to optimal pay packages.⁹⁰ Essentially, the worry is that coercive regulation is too blunt an instrument and will impose a one-size-fits-all rule on a world where there is substantial difference between firms in compensation needs. As Walker puts it, “[p]rices result in greater freedom of behavior and less distortion [than do sanctions].”⁹¹

For example, it would be a net negative socially, if some firms, in response to new information regarding the benefits of risk-taking, were unable to move away from stock options and toward restricted stock in compensation packages. A mandatory version of Section 162(m) that required all executive pay to be performance-based would therefore be problematic at least to the extent there is significant heterogeneity over such matters across firms.⁹² It is possible that the case for the heterogeneity of optimal pay packages has been overstated or at least under-supported, but it certainly holds a significant amount of influence even

89. See Walker, *supra* note 52, at 53–56.

90. See, e.g., *id.* at 51 (“Even if executive pay levels are too high systematically, we do not know the exact degree of excess pay and there is likely to be substantial heterogeneity in the amount of excess pay from firm to firm.”). Alternatively, the concern about mandatory rules could be driven simply by a fear of regulatory mistake.

91. *Id.* at 50.

92. If restricted stock dominated stock options as a pay choice across firms, then coercive regulation would only be problematic to the extent it misinterpreted the data and reached the wrong policy prescription.

among critics of executive pay practices. Accordingly, there are few serious proposals to mandate certain payment levels to executives.

For exactly the same reasons, though, we should not expect any tax intervention to be particularly aggressive. If those who are concerned about executive pay levels are unwilling to consider coercive regulation, how likely are they to consider tax penalties that truly tilt the scales when pay decisions are being made? Yet, for the reasons discussed in the previous section, absent extreme tax penalties, any tax intervention is bound to be of little effect beyond imposing costs on firms. Many may want to change compensation practices, but most are too scared of doing so and causing harm.

Aside from interfirm heterogeneity, there is also likely to be substantial intrafirm heterogeneity with regard to optimal pay packages over time. Take, for example, some firms' revealed preference for restricted stock over stock options reflecting a reevaluation of the best set of risk-taking incentives.⁹³ Even if *every* public firm in 1994 would have benefited from a coerced move to stock options via a more penal Section 162(m) regime, within a matter of years that state of affairs could have shifted. At that point, the coercive Section 162(m) regime would have produced suboptimal results making it too costly for firms to adapt. It is possible that the coercive tax law could then have been changed, but it seems more than plausible to expect any changes to lag behind the market shift. Thus, even if firms are not as different from each other in terms of compensation needs as is generally suspected, draconian tax interventions may still be problematic. This recognition too leads us along the path of relatively weak tax interventions.

VI. CONCLUSION

Given the tension between ineffectiveness and coercion, the best claim to be made for governance-driven tax interventions is that they may be able to focus the more powerful market forces on particular practices. Thus, Section 4999 could be seen as causing the need for gross-ups, which eventually prove a convenient lightning rod for outrage costs. In the same way, Section 162(m) (non-)compliance patterns could have generated political and market pressure on firms to change their practices. But note that, in either case tax is more or less beside the point. It simply serves as a tool by which some compensation norm is expressed and tested by a disclosure rule.

It would have been just as easy for, say, RiskMetrics to announce guidelines for severance multiples in 2009 in the absence of guidance from Section 280G or Section 4999. Tax rules have no monopoly on providing a focal point for market outrage—disclosure rules seem much more important in that regard. In fact, to the extent tax rules miss the

93. For a discussion of firms' preference for restricted stock over stock options, see *supra* note 82 and accompanying text.

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market's preferences in establishing that focal point, as they appear to have done with Section 162(m), they may impose unnecessary tax-related costs in the process. If tax is reliant on market forces galvanizing around the norms it establishes, why not just rely on those market forces to establish such norms? This seems particularly sensible in a world where large institutional investors and shareholder advisors are more than capable of concocting detailed compensation guidelines.

Alternatively, an ambitious researcher could seek to demonstrate that firms are not that heterogeneous with respect to their compensation needs. If that were the case, coercive regulation or tax interventions with teeth might be back on the table, at least insofar as the risk of regulatory mistake were minimized. But until that day comes, it might be best to simply refrain from using tax tools to try and achieve corporate governance outcomes.

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