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Effectiveness of Section 162(m) in controlling executive pay

Mr. Chairman I would like to thank you for inviting me to appear before your Committee today. It is a pleasure to have this opportunity to discuss the effectiveness of Section 162(m). Before I begin I would like to point out that my discussion today revolves around fine tuning section 162(m) to make it more effective, and not illegal activities such as option backdating and deductions that may have been inappropriately taken under section 162(m).

I'd also like to state up front that, based upon my own research, the research of others, and anecdotal reports, that section 162(m) has been at best, only marginally effective in limiting executive pay or in making it more responsive to performance. It is clear that executive compensation has gone up dramatically since the passage of Section 162(m). [Please refer to Table 1 on page 4 at the end of the text] However this increase has not been limited to executives of publicly held corporations, but applies to other highly sought after individuals. For example a fellow by the name of Howard Stern was reported by Forbes magazine to have earned $302 million in 2005.

Why has the tax code failed to restrain the growth in executive compensation?

In an attempt to limit executive compensation, Section 162(m), as well as Section 280(g) which defines excess parachute payments, cap the amount of payments that are deductible, leaving a corporation with three choices.

The first choice would be to cap payments at the threshold set by the code provision. There is very limited evidence that this has occurred. For example in 2005 my research indicates that at least 250 corporations paid one or more executives salary, i.e., non performance-based compensation, in excess of $1 million, 988 paid one or more executives total cash compensation in excess of $1 million, and 1,335 paid one or more executives total compensation in excess of $1 million.

The second choice would be to structure payments to maximize deductions. Corporations may do this by shifting compensation from non performance-based salary to performance-based bonuses and stock options and/or defer compensation to periods in which the deductions would be allowed. In our research, David Ryan and I have found evidence that firms have increased stock option grants in response to section 162(m). Economic theory, as well

as well as extant research, suggests this increase in riskiness of compensation will be accompanied by an increase in expected compensation – counter to the intent of the provision. The shift to more performance-based compensation also accentuates the incentives for executives to manage earnings as missing targets adversely affects bonus compensation and the value of stock options.

The third choice is to forfeit deductions. In research conducted after the passage of section 162(m), David Ryan and I noted that many firms that "qualified" their bonus plans to meet the performance based exception, added verbiage in their proxy statements saying they reserved the right to pay non deductible compensation if they determined it was in the best interest of the firm. In research conducted using data from the mid-1990's, Jennifer Yin and I found that nearly 40 percent of corporations admitted to forfeiting deductions because of section 162(m). My prediction is that this percentage is much higher today. Especially as corporations shift from stock options to restricted stock in the wake of Statement of Financial Accounting Standards 123R which required the expensing of stock options.

I should note that the choice to forfeit deductions is not limited to section 162(m). From my reading of executive compensation contracts and disclosures, I have found many corporations are willing to not only forgo deductions for excess parachute payments as defined under section 280(g), but are also grossing up the executive's compensation to pay for the excise taxes levied on the executive.

Recommendations

1. Provide increased disclosure of details in plans submitted for shareholder approval

To qualify as performance based under Section 162(m), corporations have to obtain shareholder approval of their bonus plans. While ostensibly the plans presented to shareholders have to disclose their material terms, in reality they do not. That is, they lack specificity with regard to actual plan parameters, targets, thresholds, etc. (Please see excerpt from Tyco International 2004 Stock and Incentive Plan on page 5). Disclosure of these details would allow shareholders to evaluate if thresholds for performance are adequate. In other words, allow them to determine if pay was not for performance, but for adequate performance. I believe requiring this disclosure will increase the link between pay and performance as directors and executives would be less likely to set low standards. And shareholders, now in possession of the material facts, would be less likely to approve those plans with low performance standards.

2. Require that options be market adjusted, so that the executive only benefits if the firm's share price outperforms the market index.

Under Section 162(m) stock options were de facto assumed to be performance-based, as long as they were not in the money at the time of grant, and a plan was approved by shareholders. In reality stock options are pay for performance with a threshold of 0! That is, any increase in a firm's stock price increases the value of an executive's stock options even if the firm underperforms the market, its industry index, or even risk free investments such as treasury securities. (See example on page 6). Even something as seemingly innocuous as frequent grants ensure that executives benefit from the fluctuating share prices without shareholders seeing any increase in long term value. And this is without even manipulating the system via things like backdating and spring-loading.

3. Require numerical disclosure of actual deductions forfeited and additional taxes paid.

Currently firms discuss forfeiture of deductions in their proxy statements but are exceedingly vague. For example, Wal Mart's most recent proxy statement states "***A significant portion*** of the Company's executive compensation satisfies the requirements for deductibility under Internal Revenue Code Section 162(m)." Other companies, for example Exxon-Mobil and General Motors, while paying their top executive(s) salary far in excess of $1 million dollars, give no indication of whether they forfeit deductions or not.

Disclosure of details would allow shareholders to evaluate if amounts are material and put the onus on directors to justify – which I believe would make them less likely to forfeit deductions.

In closing I would like to thank the committee for the opportunity to testify today and look forward to answering any questions you may have.

Table 1
Average CEO Compensation 1994-2005

YEAR	Salary	Cash Compensation	Total Compensation including present value of option grants	Total Compensation including profits from option exercise
1994	$516,420	$961,610	$2,165,710	$1,644,190
1995	$528,130	$1,019,400	$2,255,160	$1,948,280
1996	$545,860	$1,126,740	$3,085,240	$2,608,580
1997	$558,570	$1,167,820	$3,739,950	$3,421,990
1998	$578,710	$1,181,060	$3,886,910	$4,139,530
1999	$581,250	$1,263,090	$5,433,460	$4,425,240
2000	$604,360	$1,353,080	$6,798,500	$5,634,030
2001	$640,640	$1,308,120	$6,363,230	$5,042,440
2002	$657,880	$1,357,360	$4,958,510	$3,794,220
2003	$685,180	$1,557,670	$4,625,960	$4,412,310
2004	$707,810	$1,749,060	$5,159,520	$5,911,390
2005	$745,960	$1,946,380	$5,578,290	$7,127,200

Table 2

Use of Restricted Stock 1994-2005

Year	Number of Corporations Granting Restricted Stock	Percentage of Executive Compensation	Dollar amount of restricted Stock Granted
1994	436	4%	$648,972,450
1995	499	5%	$754,126,950
1996	534	5%	$1,052,007,170
1997	557	5%	$1,430,845,500
1998	592	7%	$1,672,348,910
1999	584	6%	$2,945,467,230
2000	574	6%	$2,269,551,410
2001	576	6%	$2,040,594,590
2002	615	11%	$2,320,166,890
2003	721	9%	$2,877,404,900
2004	854	12%	$3,570,085,930
2005	839	14%	$3,698,090,670

Example 1: Lack of disclosure of performance measures - Tyco 2004 stock and Incentive plan (Appendix B to proxy statement filed with Securities and Exchange Commission 1/28/2004)

(i) Within 90 days after the commencement of a Performance Cycle, the Committee will fix and establish in writing (A) the Performance Measures that will apply to that Performance Cycle; (B) with respect to Performance Units, the Target Amount payable to each Participant; (C) with respect to Restricted Units and Restricted Stock, the Target Vesting Percentage for each Participant; and (D) subject to subsection (d) below, the criteria for computing the amount that will be paid or will vest with respect to each level of attained performance. The Committee will also set forth the minimum level of performance, based on objective factors, that must be attained during the Performance Cycle before any Long Term Performance Award will be paid or vest, and the percentage of Performance Units that will become payable and the percentage of performance-based Restricted Units or Shares of Restricted Stock that will vest upon attainment of various levels of performance that equal or exceed the minimum required level

(ii) The Committee may, in its discretion, select Performance Measures that measure the performance of the Company or one or more business units, divisions or Subsidiaries of the Company. The Committee may select Performance Measures that are absolute or relative to the performance of one or more comparable companies or an index of comparable companies.

(iii) The Committee, in its discretion, may, on a case-by-case basis, reduce, but not increase, the amount of Long Term Performance Awards payable to any Key Employee with respect to any given Performance Cycle, provided, however, that no reduction will result in an increase in the dollar amount or number of Shares payable under any Long Term Performance Award of another Key Employee.

Example 2: How stock options might not be pay for performance

In its proxy statement filed with the Securities and Exchange Commission on March 12, 2001, Apple Computer reported that it had granted its Chief Executive Officer Steven Jobs, 20 million options in January of the previous year, and that if its share price rose at a rate of 5 percent per year, at the end of the options term, those options would be worth $548,317,503. Of course, if its share price increased by five percent per year, Apple stockholders might have preferred purchasing thirty year U. S. Treasury Bonds which offered a 6.34 percent yield risk-free at that point in time.