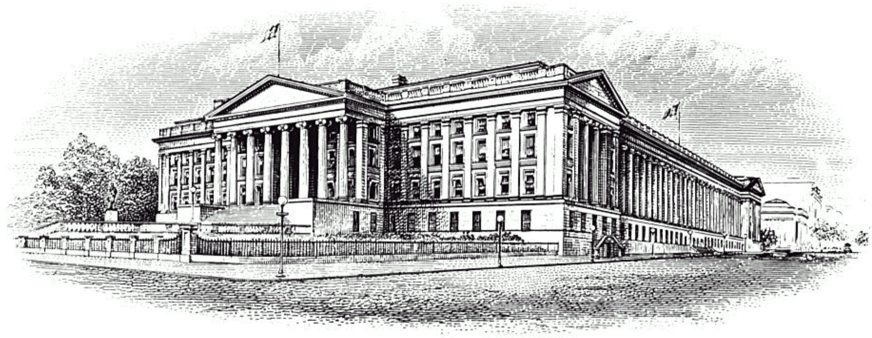

TESTIMONY OF
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FOR THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
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Mr. Chairman, Senator Baucus, and distinguished Members of the Finance Committee, thank you for the opportunity to testify regarding the Administration's legislative and regulatory proposals on executive compensation. The recent report by the staff of the Joint Committee on Taxation, prepared at the request of this Committee, reveals Enron Corporation's excessive and questionable executive compensation practices. The details of the report underscore the importance and timeliness of this hearing.

The practices of Enron make clear that executive pay is about more than just tax policy. Executive pay is an issue of corporate governance and accountability. Many investors' confidence has been adversely affected by reports of increasing executive compensation during times of deteriorating returns. Executive pay is an issue of fiscal responsibility – as the markets worry about the integrity of companies' financial statements. And executive pay is an issue of fairness – the same set of rules governing the taxation of income should apply to all taxpayers. The issues raised by the Enron report deserve the attention of legislators and regulators. We think it is important, however, to distinguish matters of tax policy from matters of corporate governance and accountability. We have specific recommendations for addressing tax policy matters through tax legislation, but we believe recent experience indicates there are risks to using the tax code as a means of influencing decisions about corporate governance and accountability. Consequently, we recommend that such concerns be dealt with directly and not through amendments to the tax code.

In reviewing the report, we noted three general points about Enron's executive compensation. First, several of the executive pay practices at Enron pushed the envelope of current law. The company permitted its executives to defer staggering amounts of income but took measures to insulate them from the risk of non-payment that the law requires as a trade-off for tax deferral. Enron was helped in this effort by out-dated rules on executive compensation – rules that the Treasury Department and the IRS have been statutorily prohibited from updating since 1978. Second, we were pleased to note that several of the pay practices at Enron have been addressed through legislation signed by President Bush last year and by recently-issued Treasury and IRS regulations. Third, the largest category of executive pay at Enron was the massive stock option gains realized by

Enron's executives. Enron's heavy use of stock options, which parallels the use of options by some other large companies, may in fact be the unintended result of legislation from past Congresses and of current financial accounting standards.

The Enron report raises another important issue, one extending beyond executive compensation. The sheer complexity of Enron's tax-motivated transactions made it very difficult for the IRS to find them and then understand what the company was attempting. In many cases, it appears that Enron intended the complexity of the transactions to frustrate detection by the IRS. In other words, Enron was deliberately hiding the ball, and that is cause for concern.

Tax Rules for Executive Compensation

It is important to understand the current tax rules for executive compensation and how those rules factored into Enron's compensation practices. The tax law does not specifically encourage executive compensation arrangements. In contrast to qualified retirement plans and employer-provided health insurance, Congress has never enacted incentives for companies to maintain or enhance executive pay arrangements. In certain cases, Congress has taken the opposite approach by imposing a tax penalty on practices considered inappropriate.

The rules on executive compensation generally have focused on three policy goals: first, to prevent tax avoidance; second, to protect the qualified-plan system; and, third, to promote good corporate governance. A few words about each of these goals are in order before turning in detail to the applicable tax rules.

First, many of the rules on executive compensation aim to prevent tax avoidance. General tax principles allow an executive to defer tax on compensation only if the executive accepts the risk that the compensation may never be paid if the company becomes insolvent or bankrupt. Executives, naturally, do not like this risk and so push for greater security and control in their deferred compensation arrangements. Many of the current rules are intended to prevent tax deferral where the executive has minimized the risk of non-payment or has realized current economic value from deferred amounts. This is an area in which we seek legislation from the Committee.

Second, certain executive compensation rules protect the integrity of the qualified plan system. To ensure the retirement security of millions of American workers and their families, the tax code provides substantial tax incentives for companies to establish and maintain qualified plans. These tax benefits are most valuable to high-paid employees, but they are available to those employees only if the qualified plans give proportional benefits to a broad cross-section of rank-and-file workers. Allowing executive pay plans to provide the same tax benefits that qualified plans can provide would undermine the qualified plan system. That, in turn, would put the retirement security of rank-and-file workers at risk. Thus, the tax code ensures that executive pay arrangements do not inappropriately compete with qualified plans.

Third, certain tax rules for executive compensation are intended to promote good corporate governance and accountability. In certain cases, Congress has determined that particular types of executive compensation arrangements harm shareholders – either because of the type of payment involved or the size of the payment involved. In response, Congress has enacted rules that impose tax penalties unless the company meets certain shareholder-protection standards.

It is useful to begin by considering the tax rules for executive compensation, focusing on how the rules apply to common types of executive pay and the compensation practices at Enron. Instead of setting out comprehensive rules, the tax law addresses executive pay through a combination of general tax principles and particular rules aimed at very specific situations. These principles and rules are found in the tax code, IRS rulings and regulations, and federal court decisions.

I want to stress the role of the Treasury Department and the IRS in executive compensation matters. Our job is to interpret and administer tax rules – in particular, to ensure that companies and executives adhere to the long-standing tax rules about how much control an executive can have over deferred compensation payouts (the "constructive receipt" rules) and how much protection the company can give the executive against non-payment if the company becomes bankrupt or insolvent (the "funding" rules). Enforcing the constructive receipt and funding rules fits within the IRS's role and capabilities. We do not believe that we are well-served by assigning to the IRS the role of enforcing rules intended to protect shareholders' interests.

We recognize that corporate governance and accountability are legitimate policy goals for executive compensation, and we understand that Congress in particular cases may conclude that legislation is needed to promote those goals. Experience indicates, however, that attempting to influence corporate governance and accountability decisions through the tax code is ineffective. Moreover, logic dictates that the issues should be dealt with directly and not through the tax code. So much as possible, the tax code should be neutral in choosing among forms of compensation.

Nonqualified Deferred Compensation – Tax Policy Issues. Nonqualified deferred compensation arrangements – including both executive bonus plans and executive pension plans – constitute one of the most common elements of executive pay. The terms of these arrangements vary widely, but their common objective is to provide tax deferral for a specified period on either an elective or non-elective basis. The compensation compounds during the deferral period at a fixed or variable rate of return, and the executive typically receives distributions of the accumulated amounts at or after retirement (with provisions for distributions under certain other circumstances, as discussed below). Many plans provide the executive with some measure of actual or hypothetical investment control over deferred amounts.

If structured correctly, the tax treatment of a nonqualified deferred compensation arrangement is as follows. The executive does not include the deferred amount in gross income until it is actually paid out to the executive. The company cannot claim a deduction for the deferred amount until the executive includes it in gross income. During the deferral period, earnings on the deferred amount generally remain taxable to the company. Thus, the law imposes a "tax tension" between the executive and the company because every dollar for which the executive defers income is a dollar for which the company must defer its deduction.

However, that tax tension only works if the executive and the company are both representing their own interests; it does not work if the company structures the pay with the sole aim of maximizing value for the executive without regard to the interests of shareholders. For example, an arrangement under which a company commits substantial assets to an irrevocable trust for the executive's benefit results in the company having less capital to re-invest in its business and may result in lower returns for shareholders – without an offsetting tax deduction for the compensation the company has set aside.

Deferred compensation arrangements must meet certain legal requirements. First, the executive cannot be in "constructive receipt" of any deferred amount. This means that an executive can defer an amount only as long as there is a "substantial limitation or restriction" on the executive's right to receive the amount. The principle of constructive receipt ensures that an executive cannot manipulate the timing of when taxes are due by turning his or her back on income that would be paid right away if the executive simply asked for it. If an executive can choose to receive deferred compensation at any time, the executive is in constructive receipt and is taxed immediately.

The IRS has applied the constructive-receipt doctrine by refusing to approve any decision to defer income and any decision about when and how that income will be paid unless the decision is made in the taxable year before the income is earned. For this reason, deferred compensation plans often provide for deferral elections to be made before the start of the taxable year. The plans often state the time when amounts will be paid out and the form of the distribution. Payout usually is made in a lump sum or in annuity or installment form at retirement or other termination of employment, death, disability, financial hardship, or after a fixed number of years.

Many plans allow an executive to make a subsequent election to defer payouts that are coming due or to change the form of the payout (or both). The plans typically require that the subsequent election be made a fixed number of months (often twelve) before the payout is due. Some plans also allow for accelerated payouts. For example, a plan may provide for an early distribution with a "haircut" – such as a forfeiture of 10 percent – or a suspension from further participation.

The IRS has had difficulty enforcing the constructive-receipt rules in disputes with taxpayers. The federal courts generally have followed an expansive interpretation of these rules, which were first written decades ago. Each court loss for the IRS has made companies and executives bolder in pushing out the line of common practice, with Treasury and the IRS prevented by Congress from updating the rules in response. The treatment by the courts of this issue has been a major factor in the expansion of deferred compensation.

Second, the tax law treats an unfunded promise to pay differently from a funded promise. Thus, the "economic benefit" doctrine and the rules governing transfers of property require that assets related to nonqualified deferred compensation remain subject to the claims of the company's general creditors along with the other general assets of the company. These rules are intended to put the executive at risk of non-payment if the company becomes bankrupt or insolvent. If a company insulates deferred compensation assets from the claims of its creditors – for example, by placing the deferred compensation in a trust or an escrow account for the exclusive benefit of the executive – the executive has a taxable economic benefit and must include the deferred compensation in gross income. Special rules, intended to backstop the qualified plan rules, provide a harsher result for discriminatory trusts by requiring the executive to pay tax currently on earnings as well.

The IRS has allowed very limited funding arrangements – commonly known as "rabbi trusts" – without triggering current tax to executives. Assets held by a rabbi trust are treated as belonging to the company, and the company continues to pay tax on any income they produce. More importantly, assets in a rabbi trust must be reachable by the general creditors of the company in the event of bankruptcy or insolvency. However, certain executive pay arrangements have increasingly stretched the limits on rabbi trusts and deferred compensation funding. In general, these arrangements – which include offshore rabbi trusts and hybrid (rabbi and non-rabbi) arrangements – are meant to keep assets away from creditors without triggering current tax to the executives.

Finally, the cash-equivalence and assignment-of-income doctrines require that an executive's interest in deferred compensation be non-assignable. This ensures that the executive cannot sell, transfer, pledge, or borrow against the deferred compensation and thereby realize economic value from it before it is paid.

The staff of the Joint Committee on Taxation found that Enron, like many large companies, provided very significant deferred compensation to its executives. It appears that Enron's deferred compensation arrangements generally complied with current law. However, Enron's arrangements also demonstrate the limitations of current law. As the company rapidly approached bankruptcy, many Enron executives were able to invoke accelerated distribution clauses. Although those accelerated distributions required a "haircut" – the executives had to forfeit 10 percent of the deferred compensation – the choice between receiving most of their deferred compensation and receiving none of their deferred compensation was surely an easy one. The practical effect of the accelerated distributions was to put these Enron executives in line ahead of the company's general creditors, allowing an end-run around the legal requirement that deferred compensation remain at risk of non-payment.

As discussed in more detail below, current law prevents Treasury and the IRS from restricting haircuts and other accelerated distribution clauses. Because of legislation passed by Congress in 1978, Treasury and IRS only have the authority to make haircut provisions *less restrictive* for executives. This is precisely the opposite of the authority we need when confronting arrangements that present potential for inappropriate tax avoidance or that undermine the qualified plan system. We strongly recommend that Congress repeal that limitation and give us the authority necessary to address both appropriate and inappropriate deferred compensation arrangements.

Nonqualified Deferred Compensation – Corporate Governance Issues. It is important to recognize that interpretation and administration of the constructive receipt and funding rules fit within the traditional role for Treasury and the IRS while enforcing shareholder protections do not. Practices that pass muster under the constructive receipt and funding rules may still present corporate governance or accountability concerns that Congress should address through legislation. If so, we recommend that Congress legislate directly rather than indirectly by trying to influence corporate governance and accountability decisions through the tax code. The tax code should be neutral. If it is not, it is likely to influence or skew decision-making one way or the other with unfortunate unintended consequences.

Recent history provides examples of what happens when Congress does or does not legislate directly on corporate governance and accountability. Last summer, Congress passed and President Bush signed the Sarbanes-Oxley Act, which includes important new rules about executive compensation. Sarbanes-Oxley enacts one of the President's retirement-security proposals by prohibiting corporate insiders from trading company stock during a "blackout" period of the company's 401(k) or other defined contribution retirement plan; it prohibits public companies from making virtually any loan to executives or directors; and it requires the chief executive officer and the chief financial officer to forfeit incentive and equity-based compensation if the company restates its financial statements. In all these cases, Sarbanes-Oxley directly addresses the problem; it does not attempt to ban or curb a practice indirectly by amending the tax code and then asking the IRS to take on the role of enforcing shareholder protections.

Compare the Sarbanes-Oxley approach with two situations where Congress has used the tax code to address shareholder-protection concerns – the $1 million cap on deductible compensation and the "golden parachute" payments. Both these sets of rules show the unintended consequences that follow from legislating corporate governance through the tax laws.

Section 162(m) provides that a public company cannot deduct compensation in excess of $1 million for any of its top five executives. The provision contains a key exception for certain "performance-based" compensation that has been approved by shareholders after full disclosure. Stock option grants ordinarily fall within this exception. Congress enacted section 162(m) on the rationale that taking away a deduction for "excessive" compensation to top executives would protect investors in public companies by instilling greater discipline in executive pay packages.

But section 162(m) has had the opposite of its intended effect. At many companies, the $1 million "cap" has effectively become a $1 million "floor" for base salary and non-performance bonuses. Additionally, the "performance-based" exception has encouraged many companies, like Enron, to shift compensation above the $1 million amount into stock options and other forms of compensation tied to the company's stock price. As the Committee is well aware, much of the recent concern about the accuracy of companies' financial statements has focused on whether tying executive pay to the company's stock price gives the executive too much incentive to manipulate earnings statements in order to affect the stock price. Finally, many companies facing the choice between losing the deduction for compensation above $1 million or trimming executive pay simply do not claim the deduction. In those cases, the loss to shareholders simply compounds – the executive still receives the same pay, and the company loses its tax deduction. What was intended as a shield for investors instead becomes a sword against them.

The golden parachute rules provide a similar example. Congress enacted these tax penalties in the mid-1980s to prevent executives from draining value out of companies in connection with corporate takeovers. Section 280G prevents the company from deducting an excess golden parachute payment, and section 4999 imposes a 20 percent excise tax on an executive who receives such a parachute payment. Again, however, the tax penalties intended to protect shareholders have had the opposite effect. In many situations, companies and executives respond to the tax penalties by agreeing that the company will "gross up" the executive – that is, pay for any penalty tax that the executive incurs on a golden parachute payment. The law treats the gross up as a parachute payment, meaning that the cost of making the executive whole spirals upward – and of course, the company cannot deduct the underlying parachute payment or the gross up payment. Thus, the golden parachute penalties have resulted in many companies paying executives *larger* parachute payments and losing their tax deductions – to the detriment of shareholders.

Congress must consider corporate governance and accountability issues when crafting legislation on executive compensation, but we recommend that Congress not use the tax code to legislate on those issues. Experience demonstrates that trying to implement shareholder protections through the tax laws likely will compound the harm to shareholders. Additionally, legislating corporate governance through the tax code puts the IRS in a position of being the primary defender of shareholder interests – a position for which the IRS simply is not well-suited. Shareholder interests are best protected by shareholders themselves and appropriate federal regulatory agencies, such as the SEC. Congress should look to the tax code to promote sound tax policy and, on executive compensation, should enable Treasury and the IRS to administer the long-standing rules concerning constructive receipt and funding of deferred compensation.

Restricted Stock and Stock Options. Restricted stock has long been a component of executive pay packages. Section 83 sets out rules for taxing restricted stock and stock options. An executive must include the fair market value of restricted stock at the time the restricted stock becomes "substantially vested" – that is, when it becomes transferable or not subject to a substantial risk of forfeiture. A special rule allows the executive to make an election to include the restricted stock in gross income prior to its becoming substantially vested. The company's deduction for the restricted stock matches the timing and amount of the executive's income.

In recent years, companies have made extensive use of stock options to compensate executives. An executive is not taxed on the receipt of a stock option (except in the highly unusual case where the option has a "readily ascertainable fair market value" when granted). Instead, the executive is taxed upon exercise of the option. At that time, the executive includes in gross income the "spread" on the option – that is, the difference between the fair market value of the stock and the amount the executive pays to exercise the option (plus any amount the executive paid to acquire the option). The company's deduction for the spread matches the timing and the amount of the executive's income.

A major consideration in the use of stock options for executive pay has been the current accounting rules for options. Under those rules, a company must account for stock-based executive compensation plans under the "fair value" method or the "intrinsic value" method. Under the fair value method (set out in FAS 123), a company expenses an option under Black-Scholes or a binomial model. This creates a charge to earnings at grant or on vesting. Under the intrinsic value method (set out in APB Opinion No. 25) an option granted at fair market value does not have any intrinsic value and results in no charge to earnings. However, a company using the intrinsic value method must disclose in a footnote to its financial statements the effect on earnings, including earnings per share, of using the fair value method to account for option grants.

Most companies, Enron included, have used the intrinsic value method for stock options, thereby avoiding any charge to earnings for this element of executive compensation. It is important to note that the tide may be changing. More companies are beginning to use the fair value method, and FASB currently has this issue under review.

Enron compensated its executives primarily with stock options. According to the Enron report, total compensation for the 200 highest-paid executives was $1.4 billion, and over $1 billion of that amount was attributable to stock options. For the years 1998 to 2000, Enron's deduction for stock-option compensation increased by more than 1,000 percent. Still, it appears from the Enron report that the company treated the option grants and exercises properly under the tax law and that Enron accounted for these options in conformity with FASB accounting rules.

It is important that the Committee's review of executive compensation consider the working of the current rules with regard to stock options and whether these rules caused the concentration of stock options in the Enron executives' pay packages.

Administration's Proposals on Executive Compensation

This Administration has a strong commitment to ensuring that the tax rules apply fairly to everyone. Those who play by the rules rightly expect that all will play by the rules. The law cannot allow executives to end-run existing rules for paying tax on amounts that are currently available to them or that have been insulated from creditors. Unfortunately, Congress in 1978 tied the hands of the Treasury Department and the IRS. The Administration proposes that Congress lift the restrictions on new regulation of executive compensation and give Treasury and the IRS full authority to address appropriate and inappropriate deferred compensation arrangements.

Section 132 of the Revenue Act of 1978. In 1978, Treasury and the IRS proposed Treasury Regulations section 1.61-16, providing for current inclusion of compensation deferred "at the taxpayer's individual option." The proposed regulation alarmed companies because the scope of the regulation was vague, and it was not clear whether all deferred compensation might be taxed currently. Companies also made strong arguments that they needed deferred compensation as part of their executive pay packages.

In response, Congress enacted section 132 of the Revenue Act of 1978 to prevent finalization of section 1.61-16. Section 132 provides that the taxable year of inclusion of any amount under a private deferred compensation plan "shall be determined in accordance with the principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation which were in effect on February 1, 1978." The broad rule-making moratorium imposed by section 132 currently prohibits Treasury and the IRS from issuing new regulations or other guidance on many aspects of nonqualified deferred compensation arrangements.

Since the enactment of section 132, Treasury and the IRS have been unable to provide new guidance about core elements of deferred compensation arrangements. New guidance is needed to ensure that the tax rules keep pace with the constant changes in deferred compensation practices and to address federal court decisions that have undercut the rules on constructive receipt. The guidance also is needed simply to update IRS ruling guidelines that were issued in 1971 and that, despite minor changes in 1992, are considered out of step with the case law.

Budget Proposal to Repeal Section 132. The Administration's budget for fiscal year 2004 proposes the repeal of section 132 of the Revenue Act of 1978 and a grant of new authority to write regulations on inappropriate deferred compensation arrangements. Last year this Committee reported legislation that would have repealed section 132, and the staff of the Joint Committee on Taxation also recommended repeal of section 132 in the Enron report.

Repeal of section 132 would greatly enhance the ability of Treasury and the IRS to write regulations addressing deferred compensation practices. This enhanced ability is appropriate for Treasury and the IRS to have, because it is a matter of enforcing tax law through the definition of taxable income. In some situations, section 132 directly constrains issuing new rules. In others, repeal of section 132 along with new statutory authority to address inappropriate arrangements would make the rules more likely to survive court challenge. Treasury and the IRS would not implement proposed section 1.61-16 as part of this authority.

The new regulations would address the following topics, among others: benefit distribution elections; initial and subsequent deferral elections; executive control over deferred amounts; shielding deferred compensation from creditors; and constructive receipt of property. Let me describe these briefly:

- Regarding *benefit distribution elections*, the regulations could address circumstances under which executives control the timing of their benefit payouts to the detriment of general creditors – for example, "haircuts" and other acceleration clauses.

- Regarding *initial and subsequent deferral elections*, the regulations could provide clearer rules to require that an executive's choice to defer income be made before the income is actually available – eliminating the executive's ability to defer tax on amounts under the executive's immediate control; the regulations also could state whether and when subsequent deferral elections are permitted.

- Regarding *executive control over deferred amounts*, the regulations could address questions about how much control an executive may have over deferred amounts – for example, whether and to what extent an executive may control the investment of deferred compensation or "swap" deferred compensation rights for stock options or life insurance arrangements.

- Regarding *shielding deferred compensation from creditors*, the new regulations could address techniques that attempt to shield assets from creditors while making it appear that the assets are reachable by creditors – for example, offshore rabbi trusts, secured trusts that "spring" into existence as a company approaches insolvency, trigger clauses that provide for automatic payouts as a company approaches insolvency, and third-party guarantees of deferred benefits.

- Regarding *constructive receipt of property*, the regulations could address when an executive is taxable on property (such as company stock) that is made available to the executive but is not actually transferred; this would give Treasury and the IRS clearer authority to address the taxation of deeply discounted stock options, resolving uncertainty about how certain old federal court decisions apply to current practices of issuing discounted options in lieu of deferred compensation.

One of the key points of the Administration's legislative proposal is the on-going flexibility that it will provide. Companies and executives regularly restructure executive pay packages, and the tax laws need to keep pace with these changes. The status quo is unacceptable as a matter of tax policy – Treasury and the IRS are actually forbidden from shaping or updating the law to address new practices. Moreover, legislation targeted at specific transactions or practices would be an incomplete response. It may not reach the new transactions or practices companies and executives develop in the future.

Furthermore, it is important that Treasury and the IRS have the authority to determine not only what types of arrangements cross the line but also to say what types of arrangements are permissible. The market pressures for executive compensation are significant, and limiting one particular inappropriate practice inevitably will lead companies and executives to develop new practices, some troublesome and some not. Effective regulation in this area requires a comprehensive approach and continual updating of the rules to respond to new developments so that companies and executives are guided to appropriate arrangements.

We need also to shape the rules for nonqualified deferred compensation to keep pace with changes in the rules for qualified plans. One of the policy goals of the nonqualified plan rules is to protect the viability and the integrity of the qualified plan system. Because of the important role that qualified plans play in providing retirement income security for millions of American workers and their families, Congress regularly reviews and updates the rules for those plans through new legislation, and Treasury and the IRS regularly issue new regulations and rulings to implement that legislation. In fact, this Committee last year reported legislation, first proposed by the President, to protect the retirement security of workers whose plans invest in employer stock. Just as the Administration urges you to take up the retirement security legislation again this year, so too we urge you to give us the tools needed to make sure that this and future legislation will maintain the balance between qualified and nonqualified plans.

To meet the policy challenges of this dynamic area, we strongly recommend that Congress repeal section 132 of the Revenue Act of 1978 and give Treasury and the IRS lasting and meaningful authority to write proper rules for taxing executive pay. Untying our hands is the only way to ensure that Treasury and the IRS can respond quickly and effectively to developments in executive compensation.

Other Recent Legislative and Regulatory Developments
Certain of the executive compensation practices discussed by the staff of the Joint Committee on Taxation in its report have been addressed either through legislation signed into law by President Bush or through regulations issued by Treasury and the IRS. Additionally, Treasury and the IRS are continually reviewing new transactions to determine whether they are appropriate.

Sarbanes-Oxley Act. The Sarbanes-Oxley Act signed by President Bush last summer addresses outside the tax code certain executive compensation issues. Sarbanes-Oxley prohibits insider trading during "blackout" periods, prohibits almost all loans from public companies to executives and directors, and requires certain executives to forfeit incentive and equity-based compensation if the company restates its financial statements. All these changes would have had a material impact on Enron's executive compensation practices, and we believe they will help curb inappropriate executive pay practices in the future.

Split-Dollar Life Insurance Arrangements. Also last summer, Treasury and the IRS proposed new regulations for taxing split-dollar life insurance arrangements. A split-dollar life insurance arrangement is a contract to allocate the benefits and, in some cases, the costs of a life insurance policy. Under a typical equity split-dollar arrangement, an executive receives an interest in the policy cash value disproportionate to the executive's share of premiums. The new regulations ended many years of uncertainty about how these arrangements are taxed and remove the tax advantage of split-dollar life insurance arrangements. Under the regulations, an executive will be taxed as receiving below-market loans from the company (if the executive owns the life insurance policy) or as receiving taxable economic benefits from the company (if the company owns the policy). Treasury and the IRS intend to finalize these regulations in the near future.

Other Arrangements. We are aware of other executive pay arrangements that raise tax policy concerns, and in some cases we anticipate publishing regulations or other guidance. For example, some executives who own stock options purport to sell those options to a family limited partnership, a family trust, or another entity in which they or their family members have a direct financial stake. This transaction is intended to defer the gain the executive would otherwise recognize on exercise of the options. We have reviewed these transactions, and we have serious concerns with them. We expect to issue a notice in the near future indicating how and why we intend to challenge them.

Of course, our review of certain transactions would potentially be different if Congress enacted our budget proposal to repeal section 132 of the Revenue Act of 1978. Section 132 ties our hands. To challenge a transaction, we have to conclude that it violates the law as in effect back in 1978. Executive compensation has changed a lot since 1978, and we need to be able to issue new rules and regulations to keep pace with changes in the market.

Finally, once we have identified a type of transaction and have determined that it fails under current law, we are able to list the transaction type and require taxpayers to disclose their participation in it. As with other types of abusive tax avoidance, we believe that listing is an important tool in tax administration and enforcement.

Summary and Closing

I thank the Committee for holding a hearing on this important topic, and I appreciate the opportunity to discuss these critical issues with you. We urge the Committee to do this year what it did last year – report legislation to repeal section 132 of the Revenue Act of 1978 to give Treasury and the IRS new authority to address deferred compensation, as proposed in the Administration's budget. We further urge the Committee to address the corporate governance and accountability issues raised by executive compensation directly rather than through the tax code. Mr. Chairman and Senator Baucus, the Office of Tax Policy would be happy to offer any assistance to you and your staff as you continue your review of this critical issue.

Mr. Chairman, this concludes my formal statement. I would be pleased to answer any questions that you or any other member may wish to ask.