

The Unreasonable Case for a Reasonable Compensation Standard in the Public Company Context: Why It Is Unreasonable to Insist on Reasonableness

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According to the American Federation of Labor and Congress of Industry Organization (“AFL-CIO”), the average chief executive officer (“CEO”) of a Standard & Poor’s (“S&P”) 500-index company received a total compensation package of nearly \$9.25 million in 2009.¹ “At the same time, millions of workers lost their jobs, their homes and their retirement savings in the worst financial crisis since the Great Depression.”² Specific examples of the vast amounts paid to corporate executives include:

- Kerry Killinger, the former CEO of Washington Mutual, who was paid \$18.1 million in 2006 and \$14.4 million in 2007.³ In 2008, Washington Mutual became the biggest bank failure in American history, was purchased by JPMorgan Chase, and its shareholders lost all of their equity in the company.⁴

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1. *Trends in CEO Pay*, AFL-CIO, <http://www.aflcio.org/corporatewatch/paywatch/pay/index.cfm> (last visited Apr. 27, 2011).

2. James Parks, *Don't Let the Chamber and Big Biz Gut Worker's Say on CEO Pay*, AFL-CIONOWBLOG (Oct. 18, 2010), <http://blog.aflcio.org/2010/10/18/dont-let-the-chamber-and-big-biz-gut-workers-say-on-ceo-pay/>.

3. Jon Talton, *Outrage Over CEO Pay is So Last Quarter*, SEATTLE TIMES, June 21, 2009, http://seattletimes.nwsouce.com/html/jontalton/2009361920_biztaltoncol21.html.

4. *Id.*; see also Chuck Saletta, *The Beauty of Washington Mutual's Collapse*, THE MOTLEY FOOL (Sept. 30, 2008), <http://www.fool.com/investing/dividends-income/2008/09/30/the-beauty-of-washington-mutuals-collapse.aspx>.

• Aubrey McClendon, CEO of Chesapeake Energy, whose 2008 compensation was \$112.5 million.⁵ Chesapeake Energy's net income for 2008 was approximately \$623 million, an almost fifty percent decline from the prior year and the lowest since 2004.⁶ In the last quarter of 2007, Chesapeake Energy's stock traded at a price no lower than \$34.90.⁷ During the last quarter of 2009, the stock hit a low of \$9.84.⁸

• Ken Lewis, the former CEO of Bank of America, whose 2008 pay totaled \$9 million.⁹ In that year, Bank of America received \$45 billion in bailout funds from the federal government¹⁰ and fired 30,000 employees.¹¹

But does high executive compensation mean excessive or unreasonable compensation? And if so, what is the

5. Talton, *supra*, note 3.

6. See CHESAPEAKE ENERGY CORP., ANNUAL REPORT PURSUANT TO SECTION 13 OR 15D OF THE SEC. EXCH. ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2008, at 33 (2009), available at www.sec.gov/edgar/shtml.

7. *Id.* at 31.

8. *Id.*

9. Talton, *supra* note 3.

10. See ANDREW M. CUOMO, NO RHYME OR REASON: THE 'HEADS I WIN, TAILS YOU LOSE' BANK BONUS CULTURE 5 (2009), available at http://www.ag.ny.gov/media_center/2009/july/pdfs/Bonus%20Report%20Final%2007.30.09.pdf. In his report, Attorney General (now Governor) Cuomo writes that:

As one would expect, in describing their compensation programs, most banks emphasize the importance of tying pay to performance As [one bank] executive put it, "employees should share in the upside when overall performance is strong and they should all share in the downside when overall performance is weak."

But despite such claims, one thing is clear from this investigation to date: there is no clear rhyme or reason to the way banks compensate and reward their employees.

. . .

. . . when the banks did well, their employees were paid well. When the banks did poorly, their employees were paid well. And when the banks did very poorly, they were bailed out by taxpayers and their employees were still paid well. Bonuses and overall compensation did not vary significantly as profits diminished.

Id. at 1.

11. Talton, *supra* note 3.

solution to curbing the problem of excessive executive pay? More specifically, should the Internal Revenue Code¹² be used as a means for regulating the actions of public companies?

This Article briefly explores these issues. In Part I, this Article provides a narrative of the excessive compensation debate. Without drawing a conclusion as to whether executive compensation is reasonably set or excessive in nature, Part I summarizes the history of public outrage surrounding executive pay. Part I also provides a short discussion of the arguments on each side of the debate. Part II of this Article analyzes Section 162(a)(1) of the Code, which provides for the deduction for a reasonable allowance for compensation. This Part explores the history behind Section 162(a)(1) and how the provision has been interpreted to apply only to compensation paid by private, closely held companies. Part II concludes by determining that the deduction for reasonable compensation allowed under Section 162(a)(1) is different than a deduction only for reasonable compensation and that there is no basis for judging the reasonableness of compensation in the public company context. Part III discusses prior tax legislation enacted in an attempt to control executive pay by setting forth objective standards of reasonableness in the public company context. In addition, Part III summarizes the literature that shows that each attempt to limit executive compensation not only failed to achieve its goal, but also may have led to executives of public corporations receiving larger pay packages. Part IV critiques a recent law review piece which argues that, not only should the Code be used as an instrument to regulate executive compensation, but that the Service should use the vague language of Section 162(a)(1) to achieve this goal.¹³ The Article concludes by urging Congress to refrain from using the tax laws to further regulate behavior in this area.

12. Unless otherwise provided herein, the term “Code” refers to the Internal Revenue Code of 1986, as amended. The term “Section” refers to a section of the Code. The term “Service” refers to the Internal Revenue Service.

13. See Aaron S.J. Zelinsky, Comment, *Taxing Unreasonable Compensation: § 162(a)(1) and Managerial Power*, 119 YALE L.J. 637, 638 (2009) (arguing that a more expansive interpretation of Section 162(a)(1) by the Service is necessary “to set executive compensation reasonably”).

I. EXECUTIVE COMPENSATION: EXCESSIVE? MAYBE.
INFLAMMATORY? DEFINITELY.

The examples of high levels of executive compensation cited at the beginning of this Article are not an aberration. One need only open a newspaper or read a magazine to see how much executives in the United States are being paid. In 2009, H. Lawrence Culp Jr. had the distinction of being the highest paid CEO according to a Forbes magazine survey of the 500 largest companies in the United States.¹⁴ Culp received \$954,000 in salary from Danaher Corporation.¹⁵ However, he also realized an additional \$140 million from the exercise of vested stock options and as a result of the vesting of stock awards.¹⁶ The next four top-paid chief executives that year were Lawrence J. Ellison of Oracle Corporation (\$130 million),¹⁷ Aubrey K. McClendon of Chesapeake Energy (\$114 million), Ray R. Irani of Occidental Petroleum (\$103 million), and David C. Nowak of Yum! Brands (\$76 million).¹⁸

A. *A History of Outrage*

While, in today's contentious political climate, the volume of the outraged voices has soared to a higher decibel,¹⁹ the anger is not new. In the 1930s, a series of

14. Scott DeCarlo, *What The Boss Makes*, FORBES.COM (Apr. 28, 2010), <http://www.forbes.com/2010/04/27/compensation-chief-executive-salary-leadership-boss-10-ceo-compensation-intro.html>.

15. *Id.*

16. *Id.*

17. *CEO Compensation*, FORBES.COM (Apr. 28, 2010), http://www.forbes.com/lists/2010/12/boss-10_Lawrence-J-Ellison_JKEX.html.

18. DeCarlo, *supra* note 14. Interestingly, total CEO compensation for 2009 decreased by thirty percent when compared to 2008 levels. *Id.* This was the third consecutive decrease in CEO compensation, following declines of eleven and fifteen percent in the prior two years. *Id.* Notwithstanding the decrease in compensation earned by these CEOs, between 2006 and 2010 Larry Ellison earned total compensation of almost \$1 billion (\$5 million in salary and \$980 million from value realized on exercised vested stock options). *Id.*

19. See, e.g., Nathan Knutt, Note, *Executive Compensation Regulation: Corporate America, Heal Thyself*, 47 ARIZ. L. REV. 493, 494 (2005) ("In recent years, executive compensation has received more media attention than ever before." (citing Amy Baldwin, *Grasso Resigns Under Pressure: \$140M Pay Package for Chairman of NYSE Sparked Public Furor*, BOSTON GLOBE, Sept. 18,

disclosures began the public outcry about excessive executive pay.²⁰ The response to these disclosures, according to Professor Wells,

was enormous, amplified by the fact that the disclosures came in the depths of the Great Depression. Executive compensation leapt onto the national agenda. In the courts, shareholders sued directors, claiming that salaries and bonuses paid at their firms were so large as to constitute “waste” of corporate assets. Those complaints gained a sympathetic hearing in the United States Supreme Court. In Washington, D.C., New Deal reformers made disclosure of executive compensation a key part of the new Federal Securities Acts [i.e., the Securities Act of 1933 and the Securities Act of 1934]. Congressmen proposed punitive taxation to squelch high executive compensation and passed laws capping salaries at corporations receiving federal contracts or aid.²¹

During the 1940s, executive compensation at public corporations declined.²² From the early 1950s through the

2003, http://www.boston.com/business/markets/articles/2003/09/18/grasso_resigns_under_pressure (discussing the resignation of NYSE Chairman Dick Grasso after his compensation package was disclosed)); Patrick McGeehan, *Again, Money Follows the Pinstripes*, N.Y. TIMES, Apr. 6, 2003, § 3, at 1 (discussing executive compensation packages in the wake of corporate scandals).

20. Harwell Wells, “No Man Can Be Worth \$1,000,000 a Year”: *The Fight Over Executive Compensation in 1930s America*, 44 U. RICH. L. REV. 689, 690 (2010) (“It was during the 1930s that the question of how much corporate executives ought to be paid and whether some were paid too much first became a national issue.”). Because there was no standardized system of reporting, exactly how much corporate executives were earning is unclear. *Id.* at 702. However, Professor Wells notes that:

[A] study of one hundred large industrial firms found the median compensation earned by a president in 1929 was \$69,728, equivalent in 2009 dollars to \$880,648. The study also revealed sharp variations. Presidents’ compensation ranged from \$10,000 a year to \$1,635,753. Though thirty presidents received compensation above \$100,000, the million-dollar pay package was an outlier. The next highest-paid president received \$605,613, and only four of the hundred received compensation above \$300,000.

Id. (footnotes omitted).

21. *Id.* at 690-91; see *Grace’s Large Pay Stirs Bonus Debate*, N.Y. TIMES, July 27, 1930, § 2, at 9 (noting the public outrage that occurred in 1929 when Bethlehem Steel paid its president a bonus of more than \$1.6 million). See also *infra* notes 69-74 and accompanying text.

22. Wells, *supra* note 20, at 758-59 (citing Carola Frydman & Raven E. Saks, *Executive Compensation: A New View from a Long-Term Perspective, 1936–2005*,

mid-1970s, executive compensation grew at a rate of 0.8% a year—more closely tracing the rate of growth in the average worker's income.²³ The controversy over executive pay faded from the public radar until the 1980s.²⁴

During the 1980s and 1990s, the compensation paid to CEOs of large, publicly traded corporations again began to rise dramatically.²⁵ In 1980, the average CEO to worker pay ratio was forty-two to one (i.e., the average CEO earned forty-two times the amount made by the average worker).²⁶ By 1990, the ratio had increased to 107 to one.²⁷ In 2000, the disparity hit an all-time high with the average CEO earning 525 times the amount earned by the average worker.²⁸ By 2009, the ratio had fallen to 263 to one.²⁹

at 7 (Fed. Reserve Bd., Working Paper No. 2007-35, 2007), available at <http://www.federalreserve.gov/pubs/feds/2007/200735/200735pap.pdf>.

23. *Id.* at 759 (citing Frydman & Saks, *supra* note 22, at 7).

24. *Id.* at 761 (“Only in the 1980s did many executives start to receive annual pay packages above \$1 million, a development that sparked outcries reminiscent of the 1930s and marks the beginning of the modern campaigns against excessive compensation.” (citations omitted)); see also Meredith R. Conway, *Money for Nothing and the Stocks for Free: Taxing Executive Compensation*, 17 CORNELL J.L. & PUB. POL’Y 383, 384 (2008) (“In the 1980s and 1990s, the public began to protest the large compensation packages executives were receiving.” (citations omitted)); Susan J. Stabile, Essay, *Is There a Role for Tax Law in Policing Executive Compensation?*, 72 ST. JOHN’S L. REV. 81, 81 (1998) (“The public often complains that executives of public corporations in the United States are overpaid.”); Charles Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 COLUM. L. REV. 1867, 1869 (1992) (reviewing GRAEF CRYSTAL, *IN SEARCH OF EXCESS* (1991)) (“Recent expressions of concern from both politicians and representatives of the investing public, however, indicate that executive compensation may now have reached such levels of outrageousness that some form of legal reaction is likely to occur.”).

25. See Frydman & Saks, *supra* note 22, at 1.

26. *Trends in CEO Pay*, *supra* note 1.

27. *Id.*

28. *Id.*; see also Michael B. Dorff, *The Group Dynamics Theory of Executive Compensation*, 28 CARDOZO L. REV. 2025, 2027 (2007) (“[W]hile in the early 1980s public company CEOs earned an average of forty-two times what factory workers earned, now they earn some four hundred times as much as factory workers do.”).

29. See *Trends in CEO Pay*, *supra* note 1; see also *Executive Pay Watch*, No. 06-16, BRIEFING BULL. (N.Y. State United Teachers Research & Educ. Servs., Latham, N.Y.), May 2006, available at <http://nysut.org/research/bulletins/20060525paywatch.html> (“Not only is this compensation high, but there is an

The protest continues today.³⁰ For example, in 2002, William J. McDonough, then-President and CEO of the Federal Reserve Bank of New York and Chairman of the Basel Committee on Banking Supervision, stated that there is “nothing in economic theory to justify the levels of executive compensation that are widely prevalent today.”³¹ In 2006, Former Securities and Exchange Commission (“SEC”) Chairman Arthur Levitt, Jr. wrote, “[t]hese huge paydays, I believe, undermine corporate governance and send a signal that boards are willing to spend shareholders’ money lavishly”³² In 2010, Professor Kenneth Davis, a professor of Law and Ethics at Fordham University Graduate School of Business, proclaimed that “[e]xecutive compensation has come to mean corporate greed. Too many managers appointed to protect the interests of shareholders are looting their companies.”³³

increasing gap between the compensation of CEOs and that of the workers. According to a study reported in the New York Times of April 9, 2006 half of Executives in 1990 earned 55 times the average workers pay compared to 104 times the average workers pay in 2004. In 2004 the top 10 percent of Executives earned at least 350 times the pay of the average worker which is up from 122 times in 1990 and 74 times in 1950.”).

30. See Knutt, *supra* note 19, at 493-94; see also Bengt Holmstrom, Pay Without Performance and the Managerial Power Hypothesis: A Comment, 30 J. CORP. L. 703, 706 (2005) (reviewing LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004)) (“Exorbitant levels of executive pay have upset the public and the politicians.”); Michael S. Weisbach, *Optimal Executive Compensation versus Managerial Power: A Review of Lucian Bebchuk and Jesse Fried’s Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, 45 J. ECON. LITERATURE, 419, 419 (2007) (book review) (“Over the last few years, corporate governance has become a popular topic in both the business and academic press. The large number of high-publicity scandals, the seemingly enormous salaries paid to executives, and the celebrity status of CEOs has created unprecedented public interest in corporate governance.”).

31. William J. McDonough, President & Chief Exec. Officer, Fed. Reserve Bank of N.Y., Remarks at the William Taylor Memorial Lecture: Issues of Corporate Governance (Sept. 29, 2002).

32. Arthur Levitt, Jr., *Corporate Culture and the Problem of Executive Compensation*, 30 J. CORP. L. 749, 749 (2005).

33. Kenneth R. Davis, *Taking Stock—Salary and Options Too: The Looting of Corporate America*, 69 MD. L. REV. 419, 419 (2010). The public outrage has, not surprisingly, spilled over to the legislators that such public elects. Professor Davis notes that “[a]n enraged Charles Grassley, the ranking Republican of the Senate Finance Committee, declared that AIG employees who took taxpayer

B. *Is Compensation Excessive?*

Despite the large amount written about excessive compensation, there is a vigorous debate regarding whether such pay packages are truly excessive. According to Professor Lowenstein,

Executive compensation is like global warming; true believers and doubters are sharply arrayed against one another debating whether there is a problem and, if so, what are its causes and cures. Some observers believe that the compensation paid to America's top executives is clearly excessive, while others doubt that a problem exists.³⁴

The group that believes that executive compensation is excessive can be divided into two separate factions.³⁵ The first group focuses on executive compensation “as a problem that both reflects and exacerbates poor corporate governance,” while the second group “focuses on executive compensation as a source of increasing economic, political, and social inequality.”³⁶ This Article focuses only on the first concern, leaving the economic, political, and social policy discussions for others to debate.³⁷

money should ‘follow the Japanese model and come before the American people and take that deep bow and say I’m sorry, and then either do one of two things—resign, or go commit suicide.’” *Id.* at 421 (citations omitted).

34. Mark J. Loewenstein, *The Conundrum of Executive Compensation*, 35 WAKE FOREST L. REV. 1, 2 (2000) (footnotes omitted). However, Professor Loewenstein concludes that those who believe executive compensation is excessive are more numerous. *Id.* at 2 n.2.

35. See Brett H. McDonnell, *Two Goals for Executive Compensation Reform*, 52 N.Y.L. SCH. L. REV. 585, 586 (2007) (“[T]here are at least two very different types of concerns that lead to two very dissimilar goals for proposals to reform executive compensation.”).

36. *Id.* (citations omitted).

37. For an example of commentators focused on these policy concerns, see RUSSELL S. WHELTON, EFFECTS OF EXCESSIVE CEO PAY ON U.S. SOCIETY 15 (2006), available at www.svsu.edu/emplibrary/Whelton%article.pdf (“Excessive pay, defined as compensation that is 20% or greater than the national average CEO salary, has changed the relationship between CEOs and stakeholders. While the free market society can present valid reasons for the escalation in wages, the overwhelming majority of data concludes that the impact on society is detrimental.”). Similarly, Professor Linda Barris notes that:

While the cost-per-share to the corporation for a multi-million dollar compensation package is small, the cost to the firm in terms of human

Professors Lucian Bebchuk and Jesse Fried authored the seminal work reflecting the first of these factions, arguing that executive compensation is inefficient and excessive.³⁸ Their “managerial power” theory states that compensation paid to corporate executives has often “deviated from arm’s-length contracting because directors have been influenced by management, sympathetic to executives, insufficiently motivated to bargain over

capital is far greater. Those same pay packages which provide executives with incentives create disincentives for employees. Executive compensation strikes at key economic issues: employee morale and productivity.

Linda J. Barris, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay*, 68 IND. L.J. 59, 69-70 (1992). In discussing reasons for regulating executive compensation, Professor Barris concludes that “[t]he theory . . . is simple: Public policy does not support extreme distortions in income distribution, and taxpayers should not have to subsidize high-level executives through business tax deductions.” *Id.* at 79.

38. LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004); see GRAEF CRYSTAL, *IN SEARCH OF EXCESS* 42-50 (1991) (describing how a CEO will hire a compensation consultant to raise arguments persuasive to a compensation committee made up of outside directors, themselves frequently CEOs of other companies, who are “not very adept at statistics and corporate finance,” but who are friends with the CEO and themselves concerned about their own salaries); Carl T. Bogus, *Excessive Executive Compensation and the Failure of Corporate Democracy*, 41 BUFF. L. REV. 1, 37-39 (1993) (applying the law of small group dynamics to the relationship between the board of directors and the chief executive officer); Michael B. Dorff, *Softening Pharaoh’s Heart: Harnessing Altruistic Theory and Behavioral Law and Economics to Rein in Executive Salaries*, 51 BUFF. L. REV. 811, 825-26 (2003) (showing that there is no evidence to support a link between executive ability and compensation); Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1489-93 (1989) (CEO compensation practices do not align interests of managers and shareholders); Edward A. Zelinsky, *The Tax Policy Case for Denying Deductibility to Excessive Executive Compensation: Disguised Dividends, Reasonable Compensation, and the Protection of the Corporate Income Tax Base*, 58 TAX NOTES 1123, 1125 (1993) (“The contemporary critique of managerial remuneration suggests that, in determining arm’s length salaries for corporate executives, the salaries paid to [other CEOs] are not acceptable comparables, since those salaries are also set in a closed system by self-dealing managers and are thus inflated beyond competitive levels.”). *But see* Tod Perry & Marc Zenner, *CEO Compensation in the 1990s: Shareholder Alignment or Shareholder Expropriation?*, 35 WAKE FOREST L. REV. 123, 123-26, 144 (2000) (concluding that the preponderance of evidence points toward increased alignment of the interests of shareholders and managers).

compensation, or simply ineffectual in overseeing compensation.”³⁹ This leads to a board and management that set compensation in a manner inconsistent with shareholder preferences.⁴⁰ This managerial power arises because boards of directors at public companies are beholden to corporations’ top executives, in large part, because corporate management controls the director nomination process.⁴¹ In other words, corporate compensation committees do little to protect the corporation in its pay negotiations with the CEO, which leads to levels of executive pay not based on a market dynamic.⁴² The only constraint on this process is outrage—either from shareholders or the general public—which only works in extreme cases of executive overcompensation.⁴³

39. BEBCHUK & FRIED, *supra* note 38, at 4.

40. *Id.* at 61-62.

41. *Id.* at 25-27.

42. See Lawton W. Hawkins, *Compensation Representatives: A Prudent Solution to Excessive CEO Pay*, 72 BROOK. L. REV. 449, 453-54 (2007).

43. BEBCHUK & FRIED, *supra* note 38, at 64-70. A number of commentators have criticized the analysis of Professors Bebchuk and Fried. See, for example, John E. Core et al., *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142 (2005) (reviewing LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004)), where the authors note that:

While we agree with some of the analysis offered in *Pay Without Performance*, we think it is important to put its arguments into perspective. In a nutshell, the key issue is whether the problems Bebchuk and Fried discuss are examples of a few bad apples or are evidence that the whole barrel is rotten. The essence of their claim that the entire barrel is bad rests on the following assumption: If contracts are optimal, they do not reflect managerial power, and if contracts reflect managerial power, they are suboptimal. The authors view evidence of managerial power as evidence that the system is failing and that reform is needed.

We agree that it is useful to consider the effect of managerial power on compensation, but disagree with their interpretation of the consequences of such power. It is true that contract structures reflect CEO power, and that CEOs with more power get more pay, but this does not necessarily lead to the conclusion that CEO pay is not optimized for shareholders, nor does it imply that CEO pay needs reform.

More generally, our Review points out that Bebchuk and Fried have missed some important aspects of executive pay and incentives. As a

The other side of the debate—those who believe that executive compensation is reasonable—generally argue that market competition sets the prices for such pay.⁴⁴ Professor Nicholas Wolfson notes that “there is an active market for

result, they have not shown that there are systematic failures with U.S. CEO compensation, and therefore have not shown that reform is needed.

Id. at 1143-44 (footnotes omitted). *See also* Holmstrom, *supra* note 30, at 704 (“[I]t is a big leap from the criticism of executive pay to the authors’ main conclusion that there is a need for wholesale reform of corporate governance.”).

44. *See* Robert Thomas, *Is Corporate Executive Compensation Excessive?*, in *THE ATTACK ON CORPORATE AMERICA* 276, 278 (M. Bruce Johnson ed., 1978) (“Competition among corporations . . . sets the level of executive compensation.”); Joseph E. Bachelder, *Comments on Pay Without Performance*, 30 J. CORP. L. 777, 778-83 (2005); Frank H. Easterbrook, *Managers’ Discretion and Investors’ Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 542-43 (1984) (“[C]ompetition over the course of years and decades induces managers to act in the interests of investors.”); Core et al., *supra* note 43, at 1144 (expressing doubt that Bebchuk and Fried have shown there are systematic failures in U.S. executive compensation); Andrew R. Brownstein & Morris J. Panner, *Who Should Set CEO Pay? The Press? Congress? Shareholders?*, HARV. BUS. REV., May-June 1992, at 28, 30-32; Kevin J. Murphy, *Top Executives Are Worth Every Nickel They Get*, HARV. BUS. REV., Mar.-Apr. 1986, at 125, 125-26; Frydman & Saks, *supra* note 22, at 3-4 (noting different theories put forward to explain the rise in executive compensation); *cf.* Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225, 227 (1990) (offering hypothesis that political forces implicitly regulate executive compensation). Professor Kevin Murphy concludes:

The BFW [Bebchuk, Fried, and Professor David Walker from Boston University] analysis is comprehensive and provocative, and their evidence that pay practices reflect more than optimal contracting concerns is compelling. Equally compelling is their evidence that most pay decisions are not made by truly independent boards in legitimate arm's length transactions. Ultimately, though, their managerial power view is both problematic as a theoretical matter, and too simplistic to explain executive pay practices. Moreover, their hypothesis is largely inconsistent with the most important development in executive compensation practices: the recent escalation in option-based compensation for both top-level and lower-level executives. Overall, their prescription to focus on rent extraction in examining “the regulation and practice of corporate governance” is potentially misguided and diverts attention from more important issues regarding executive compensation.

Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 850 (2002).

corporate executives” and that excess wages “are eliminated by the active competition for [these] positions.”⁴⁵

One reason for the high levels of executive pay is the demand for “top executive talent.”⁴⁶ Professor Bengt Holmstrom notes that “in the second half of the 1990s, executives had lucrative opportunities outside their traditional jobs—as investors or partners in red-hot venture and buy-out markets, for instance, or as entrepreneurs.”⁴⁷ However, the increase in executive pay cannot be attributed solely to demand. Rather, Professor Holmstrom concludes that a large portion of such increase stems from the overall rise in shareholder value—which led, through the increased use of stock options for corporate executives, to large increases in executive compensation.⁴⁸

Professor Stephen Bainbridge notes that the ideas presented by Bebchuk and Fried are neither new, complete, nor relevant.⁴⁹ With respect to the originality of the arguments contained in *Pay Without Performance*, Professor Bainbridge notes that similar ideas about the separation of corporate ownership and control can be traced

45. Nicholas Wolfson, *A Critique of Corporate Law*, 34 U. MIAMI L. REV. 959, 977 (1980). Wolfson concludes by stating “both empirical evidence and responsible economic theory indicate that shirking in the form of ‘excessive’ compensation is controlled by market forces.” *Id.* at 978.

46. Holmstrom, *supra* note 30, at 706 (citations omitted).

47. *Id.* at 706-07.

48. *Id.* at 707. Ironically, it was Congress’ attempt to reform executive pay through the enactment of Section 162(m) that has led to the increased use of equity compensation. *See infra* text accompanying note 189.

49. Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615, 1626-43 (2005) (reviewing LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004)). While this statement appears to reflect a high degree of skepticism of Bebchuk and Fried’s research, Professor Bainbridge concludes his review of their work by stating that:

Bebchuk and Fried are to be praised for having written a book that makes highly technical doctrinal and economic analysis accessible to the educated lay reader, while not dumbing down some very sophisticated analysis. They have laid out a provocative argument and, in many respects, offered considerable supporting evidence. Unquestionably, they have made a valuable and provocative contribution to the literature.

Id. at 1662.

back to Berle and Means in the 1930s, and to Alfred Marshall and William W. Cook in the 1890s.⁵⁰ Even the idea that corporate managers control their own pay was discussed more than a decade before Bebchuk and Fried published *Pay Without Performance*.⁵¹

In discussing the completeness of their claims, Professor Bainbridge states “Bebchuk and Fried cannot exclude competing explanations for much of the evidence on which they rely.”⁵² In other words, Bebchuk and Fried’s interpretation of the data is “often plausible but contestable.”⁵³ Other commentators also note that the managerial power model can exist side by side with optimal contracting theories.⁵⁴ Thus, even where managerial power exists, “observed contracts anticipate and try to minimize the costs of this power, and therefore may be written optimally.”⁵⁵

50. *Id.* at 1626-27 (citing HERBERT HOVENKAMP, ENTERPRISE AND AMERICAN LAW: 1836-1937, at 16, 357 (1991)); *see also* ADOLF A. BERLE & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 68-118 (1932).

51. Bainbridge, *supra* note 49, at 1627 (citing Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 83 S.M.U. L. REV. 127, 127-128 (1996)). Professor Elson stated that:

The most significant problem facing corporate America today is the management-dominated, passive board of directors. A common occurrence in many of our largest corporations is that passive boards are responsible for excessive executive compensation and, more importantly, poor corporate performance. The board, created to monitor management in order to ensure effective decision-making, has evolved into a body that, in its most extreme form, simply “rubber stamps” executive prerogative. Management, no longer checked, freely engages in conduct that is slothful, ill-directed, or self-dealing—all to the corporation’s detriment.

Elson, *supra*, at 127-28.

52. Bainbridge, *supra* note 49, at 1628.

53. *Id.* at 1629.

54. *E.g.*, Core et al., *supra* note 43, at 1159-60.

55. *Id.* at 1160. In discussing significant research done by other scholars in this area, Professor Bainbridge notes that:

These examples are not intended as a comprehensive rebuttal of the managerial power model, but rather to highlight the possibility that many executive compensation practices are at least as consistent with an arm’s-length-bargaining model as the managerial power model.

Finally, Professor Bainbridge argues that Bebchuk and Fried's theory may be less relevant than they claim since there is "relatively little evidence that CEOs are motivated by pay" ⁵⁶ If this claim is correct, and pay and performance are decoupled, "many of the practices Bebchuk and Fried condemn as products of management power take on a more benign appearance." ⁵⁷ If, however, there is a link between pay and performance—a link which the evidence suggests is weaker than "commonly supposed"—"Bebchuk and Fried's observation that executives receive a considerable amount of pay that is not performance-sensitive has far less policy-making traction than they claim for it." ⁵⁸

In their 2007 book, *Myths and Realities of Executive Pay*, Ira Kay and Steven Van Putten present a different view of executive pay than Bebchuk and Fried—one that establishes a successful pay for performance structure, an efficient labor market, and an effective corporate governance model. ⁵⁹ In response to the argument that executive pay is not tied to corporate performance, Kay and Van Putten set forth substantial evidence to support their conclusion that "[f]or most companies, there is substantial pay-for-performance sensitivity. Simply put, high performance generates high pay, and low performance generates low pay." ⁶⁰ Based on their analysis, Kay and Van Putten make a number of conclusions about the U.S. pay for performance system, including the fact that executives generally receive only a small portion of the value that they create for corporations and their shareholders, ⁶¹ that

This Review Essay is not intended to provide a complete literature review. Instructively, however, a number of scholars who have undertaken a more exhaustive review of the literature have concluded that the evidence is considerably less compelling than Bebchuk and Fried claim.

Bainbridge, *supra* note 49, at 1631 (footnote omitted).

56. Bainbridge, *supra* note 49, at 1632.

57. *Id.* at 1634.

58. *Id.* at 1637.

59. IRA T. KAY & STEVEN VAN PUTTEN, MYTHS AND REALITIES OF EXECUTIVE PAY 1-3 (2007).

60. *Id.* at 10.

61. *Id.* at 10-12.

executive pay rises and falls with corporate financial performance,⁶² and that a highly competitive executive labor market leads to pay packages that reflect the need to recruit qualified talent.⁶³

In discussing the managerial power theory, Kay and Van Putten note that the research sparked by *Pay Without Performance* generally criticizes the managerial power theory and rejects the policy implications that flow therefrom.⁶⁴ These authors conclude that, based on the

62. *Id.* at 15-17.

63. *Id.* at 17-20.

64. *Id.* at 30; see, e.g., Iman Anabtawi, *Explaining Pay Without Performance: The Tournament Alternative*, 54 EMORY L.J. 1557, 1578 (2005) (“One theoretical weakness of the managerial power approach is that it assumes that CEO influence over the compensation process translates into inefficient compensation contracts. This assumption ignores, however, the fact that in the principal-agent model firm performance is itself a function of the compensation contract. In other words, by specifying a more efficient compensation contract, the incomes of both shareholders and executives can be increased.”); Randall S. Thomas, *Explaining the International CEO Pay Gap: Board Capture or Market Driven?*, 57 VAND. L. REV. 1171, 1173-82 (2004) (arguing that the pay gap between U.S. and international CEOs is market driven); Core et al., *supra* note 43, at 1182 (“Bebchuk and Fried’s policy recommendations for government intervention are based on their assessment that executive pay practices are failing, which we do not believe to be true. Therefore, we see no broad justification for the policy recommendations that they give.”); see also *supra* note 44 (Professor Murphy quote). Kay and Van Putten note that:

Most academics, board members, and compensation consultants, and certainly all large-company executives, think that Bebchuk and Fried’s theory is deeply flawed. In fact, the academics—the most independent and scientific commentators in this whole matter—have found that the U.S. executive compensation model benefits the U.S. economy

But Bebchuk and Fried’s theory has received a warm response from the media, including the *New York Times* and *The Economist*; selected executive compensation critics, such as Arthur Levitt, former SEC chairman; and some institutional investors—especially those representing unionized employees and state employees. And even though the larger institutional funds have criticisms of executive pay, they are generally satisfied with the outcome: the return to them as shareholders. If they could achieve the same returns for less executive pay, they would certainly install that model. Their shareholding and proxy voting behavior suggests, however, that they doubt a different model would produce the same results.

KAY & VAN PUTTEN, *supra* note 59, at 33.

research, “while there is a great amount of managerial power inside the corporation, it is trumped by pay-for-performance, balanced bargaining power, and other attributes of the CEO labor market.”⁶⁵

So, has either side convincingly made its case regarding the reasonableness of executive compensation? Perhaps the best way to conclude a summary of the existing debate over executive compensation is to end where we began, noting that:

As with most normative questions, the question of whether CEOs are appropriately compensated perhaps cannot be decided based on compelling, conclusive evidence to support an answer. . . . Ultimately, whether one believes that CEOs are over or appropriately compensated probably is a personal judgment. Each of us may have our own personal answer, but it would be difficult to argue that it is the right answer.

. . . Whether executive compensation is excessive or equitable appears to remain an open question in spite of the many arguments and research on the topic.⁶⁶

65. KAY & VAN PUTTEN, *supra* note 59, at 30. In one challenge to Bebchuk and Fried, Professor Randall Thomas proposes five alternative theories for why U.S. CEOs are paid more than their foreign counterparts. Thomas, *supra* note 64, at 1176. Professor Thomas concludes:

In my view, economic forces are the most important factor in the determination of the market pay rate for CEOs and other top executives. The CEO's contribution to her firm's value, or the top executive's best alternative job opportunities, are powerful explanations of her relative pay scale. It seems unlikely that these values are fixed through some massive secret conspiracy to keep managerial pay levels high.

Id. at 1265.

66. Donald Nichols & Chandra Subramaniam, *Executive Compensation: Excessive or Equitable?*, 29 J. BUS. ETHICS 339, 349 (2001). Even if corporate executives are overcompensated, this may not represent a problem. Professor Yablon states that:

But is such overcompensation a *problem*? The dominant perspective in the press and among many politicians is to assume that there is something deeply wrong when corporate CEOs pay themselves millions in salaries while closing plants and laying off thousands of workers. But this is fundamentally an argument about appearances. . . .

While it is hard to find anyone in public life willing to respond with a hearty “So what?” to the evidence that American CEOs are grossly

C. *Abandoned Attempts to Regulate Executive Pay*

Although the question of whether executive compensation is excessive remains an open one, there have been attempts to limit such compensation through the Code since the public outrage over executive pay began.⁶⁷ While it might seem prudent to determine that a problem exists before attempting to provide solutions,⁶⁸ Congress has not seen fit to wait.

For example, in the 1930s, there were several unsuccessful attempts to impose excise taxes on “excessive” compensation. In 1932, the Senate Finance Committee proposed both adding an eighty percent surtax on compensation above \$75,000 and eliminating the corporation’s deduction for the same.⁶⁹ According to the

overcompensated, there is much economic literature to support precisely that position. Economic theory has long recognized that whenever there is a separation of ownership and control in a firm, a potential conflict of interest is created between the owners of the firm and the agents they hire to run the business. This problem of agency cost is exacerbated in the public corporation, no single owner of which has a sufficient incentive to monitor corporate management and to seek the reduction of such agency costs. It is perfectly plausible to argue, and many economists do, that a certain amount of self-serving behavior by corporate managers—including payment to themselves of excessive compensation—is simply the cost of doing business and part of the costs inherent in the use of the public corporation as the primary vehicle for carrying on economic activity in the United States.

Yablon, *supra* note 24, at 1874-75 (footnotes omitted). *But see* Jerry W. Markham, *Regulating Excessive Executive Compensation—Why Bother?*, 2 J. BUS. & TECH. L. 277 (2007) (asking not “so what?” but “why bother?” with respect to the question of whether the government should have a role in policing executive compensation).

67. *See infra* text accompanying notes 69-83.

68. This is not an original notion. *See* Loewenstein, *supra* note 34, at 4 (“No serious consideration of solutions to the ‘problem’ of executive compensation should proceed before determining whether, in fact, CEOs are overpaid.”).

69. *See* S. REP. NO. 72-665, at 13-14 (1932). The Senate Report notes that with respect to the eighty percent surtax on excess compensation, the “committee believes that under present circumstances compensation, to the extent that it exceeds compensation at a rate of \$75,000 per year, should not be regarded as reasonable compensation for income-tax purposes . . .” *Id.* at 13. With respect to the compensation deduction, the report notes that “the payment of any compensation to any person of an amount which exceeds compensation at the rate of \$75,000 per year should be regarded, for income tax purposes, as in

Report of the Senate Finance Committee, the “large amounts of compensation, particularly in the form of bonuses, emoluments, and rewards frequently paid to the officials of corporations are greatly in excess of reasonable compensation.”⁷⁰ In 1934, a brief outcry for taxes made a similar proposal appear more likely to pass.⁷¹ But limits on executive compensation failed to appear in the Revenue Act of 1934.⁷² During the drafting of the 1934 Act, Texas Senator William McFarlane proposed the creation of a steeply graduated income tax that “would confiscate incomes as they approached \$1 million.”⁷³ Although Senator McFarlane’s highly-progressive tax rates would have affected all incomes (whether from executive compensation or otherwise), his unsubstantiated statements made on the Senate floor—citing salaries and bonuses granted to executives at large U.S. corporations (specifically, American Tobacco and Bethlehem Steel)—reflected his belief that the increased compensation paid to corporate executives was not justified by an increase in corporate responsibilities.⁷⁴

excess of reasonable compensation for personal services actually rendered”
Id. at 14.

70. *Id.* at 13.

71. See Wells, *supra* note 20, at 751 (citing *Big Salaries Bring Demand for Curbs*, N.Y. TIMES, Mar. 5, 1934, at 6); see also Philip M. Payne, *Corporation Salaries and Bonuses and The Federal Income Tax*, 12 TAX. MAG. 301, 333-34 (1934) (noting these amendments proposed by Senator Al Gore Sr. and another proposal by Senator McKellar that would have denied a deduction for salary or compensation in excess of \$50,000 per year).

72. See Wells, *supra* note 20, at 751 (citing MARK H. LEFF, *THE LIMITS OF SYMBOLIC REFORM: THE NEW DEAL AND TAXATION, 1933-1939*, at 88-89 (1984)).

73. *Id.* (citing 79 CONG. REC. 10,983-84 (1935) (statement of Sen. McFarlane)). Senator McFarlane’s proposal called for a surtax to be placed on net income which would have the effect of “placing a ceiling on personal incomes of not to exceed \$1,000 per week or about \$52,000 net per year.” 79 CONG. REC. 10,984 (1935) (statement of Sen. McFarlane).

74. 79 CONG. REC. 10,984 (1935) (statement of Sen. McFarlane). Senator McFarlane concluded that:

The additional pay in no sense represents earned incomes, but are paid by reason of the fact that these individuals are able to dominate and control oftentimes with very little actual ownership of the business. The excessive salaries which they receive represent accumulated profits diverted from the stockholders into their pockets. The salary of the President of this country is only \$75,000. I believe no officer in commercial enterprises should receive more.

In 1992, shortly before the enactment of Section 162(m), Senator Tom Harkin introduced legislation that would have amended Section 162 to redefine the term “reasonable allowance for salaries or other compensation” to include only the first \$500,000.⁷⁵ Senator Tom Daschle introduced a similar bill that would have allowed the \$500,000 limitation to be increased for cost-of-living adjustments.⁷⁶

In another attempt to legislate executive pay, Representative Martin Sabo introduced a bill in every session of Congress beginning in 1991 until his retirement in 2006 that would have disallowed a tax deduction for executive salaries in excess of twenty-five times the salary of the lowest paid employee in the same organization.⁷⁷ None of these bills were ever voted upon.⁷⁸ After

Id.

75. S. 2329, 102d Cong. (1992). *See also infra* Part III.A.

76. S. 2261, 102d Cong. (1992).

77. *See* Income Disparities Act of 1991, H.R. 3056, 102nd Cong. (1991); Income Equity Act of 1993, H.R. 3278, 103rd Cong. (1993); Income Equity Act of 1995, H.R. 620, 104th Cong. (1995); Income Equity Act of 1997, H.R. 687, 105th Cong. (1997); Income Equity Act of 1999, H.R. 740, 106th Cong. (1999); Income Equity Act of 2001, H.R. 2691, 107th Cong. (2001); Income Equity Act of 2003, H.R. 2888, 108th Cong. (2003); Income Equity Act of 2005, H.R. 3260, 109th Cong. (2005).

78. An article in *New York Magazine* best summarizes the legislation proposed by Representative Sabo:

On the House side, a rather poorly thought-out and simplistic bill by Democrat Martin Sabo of Minnesota would set an arbitrary ceiling on how much money chief executives should be paid; any portion of an executive’s salary that is more than 25 times the salary of the lowest-paid full-time employee in the company would not be deductible by the company as a business expense.

Why 25 times? Sabo explains that he used the current minimum wage as a starting point and found that a 25-times increase would result in a salary of roughly \$200,000. “That’s what the President of the United States gets,” says Sabo. “Why should some corporate executive get more?”

Christopher Byron, *Strike It Rich: On the CEO Pay Patrol*, N.Y. MAG., Feb. 17, 1992, at 21. Representative Sabo’s rationale for limiting executive compensation to the salary paid to the President of the United States is reminiscent of the statements made by Senator McFarlane more than one-half century earlier. *See* 79 Cong. Rec. 10,984 (1935) (statement of Sen. McFarlane). Both statements might remind readers of Babe Ruth’s statement regarding his own compensation. In 1930, when asked by a reporter what he thought of the fact

Representative Sabo retired from the House of Representatives, Representative Barbara Lee assumed responsibility for his crusade.⁷⁹ To date, Representative Lee's bills have met the same fate.

A more recent attempt to enact tax provisions to regulate executive pay arose in the wake of widespread public outrage over reports of American International Group, Inc.'s ("AIG") payment of large retention bonuses after receiving more than \$170 billion in government assistance.⁸⁰ In 2009, the House of Representatives passed a

that his annual salary of \$80,000 was greater than the \$75,000 annual salary earned by President Hoover. Ruth responded, "I know, but I had a better year than Hoover." See Norman Chad, *Just a Little History*, WASH. POST, Sept. 27, 2004, <http://www.washingtonpost.com/wp-dyn/articles/A52356-2004Sep26.html>.

79. Income Equity Act of 2007, H.R. 3876, 110th Cong. (2007); Income Equity Act of 2009, H.R. 1594, 111th Cong. (2009); Income Equity Act of 2011, H.R. 382, 112th Cong. (2011). It should be noted that, beginning with the 2009 bill, Representative Lee's proposed legislation would eliminate the deduction for executive compensation in excess of the greater of \$500,000 or twenty-five times the compensation paid any other employee. In addition, such legislation expands the definition of "compensation" to include a wider array of fringe benefits. Compare H.R. 3876 with H.R. 1594.

80. See, for example, Tim Reid, *Outrage Over AIG Bonuses Threatens to Derail Obama's Rescue Plans*, TIMES (London), Mar. 19, 2009, http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article5934395.ece, describing the "tidal wave of public anger" as follows:

The enormous public anger and outrage on Capitol Hill stems from the fact that the bonuses paid to 418 employees, including \$1 million each to 73 people, came after the company had been rescued with \$170 billion of taxpayers' money. It comprises the biggest injection of public cash into a single company since the financial crisis began last year, and another \$30 billion will be paid soon.

Id.; see also Miriam A. Cherry & Jarrod Wong, *Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes*, 94 MINN. L. REV. 368, 369 (2009) ("Responding to public outrage, the House of Representatives sought to impose a retroactive marginal taxation rate of ninety percent on the AIG bonuses (as of the date of this writing, the bonus tax had passed in the House of Representatives, but not the Senate)." (citing John Christoffersen, *AIG Execs' Lavish Homes Draw Busload of Activists*, SEATTLE TIMES, Mar. 22, 2009, at A4); Michael M. Phillips, *Outrage Overflows on Capitol Hill as Lawmakers Denounce Bonuses*, WALL ST. J., Mar. 19, 2009, at A4; Liam Plevin et al., *AIG Faces Growing Wrath over Payouts*, WALL ST. J., Mar. 16, 2009, at A1; Jonathan Weisman et al., *Treasury Will Make Grab to Recoup Bonus Funds*, WALL ST. J., Mar. 18, 2009, at A1. For an example of a statement of Congressional outrage, see *supra* note 33.

bill that would have imposed a tax at a rate of ninety percent on certain bonuses paid to individuals with adjusted gross incomes over \$250,000 by financial institutions that received more than \$5 billion in federal assistance under the Treasury Department's Troubled Asset Relief Program ("TARP").⁸¹ The tax imposed by the proposed bill, H.R. 1586, would have been in addition to any other tax imposed by the Code (including any income tax), but would not have applied if the recipient irrevocably waived his or her entitlement to such bonus or returned such amount to his or her employer "before the close of the taxable year in which such payment [was] due."⁸² A similar bill was introduced in the Senate, but was never brought to a vote.⁸³

Not all attempts to limit executive compensation through the Code have failed to survive the legislative process. In fact, several provisions currently exist to deny a deduction, impose a tax surcharge, or to accelerate the inclusion of income for compensation that Congress has determined should not be subsidized by the taxpayers.⁸⁴ However, as discussed herein, all of these provisions set forth bright-line standards to determine which portion of the compensation qualifies for a tax deduction and for which portion public subsidization is unavailable.⁸⁵

81. See H.R. 1586, 111th Cong. (2009) (imposing an additional tax on bonuses received from certain TARP recipients).

82. *Id.*

83. See Compensation Fairness Act of 2009, S. 651, 111th Cong. (2009). The Senate version of the excise tax on excessive compensation provided for a tax at a rate of seventy percent—split equally between the employer and the employee—on the amount of any bonus payment in excess of \$50,000 paid to certain employees of TARP recipients. *Id.* It should be noted that outrage over the TARP bailout did result in some changes to the Code affecting the executive compensation provisions in Sections 162(m) and 280G. See Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 302, 122 Stat. 3765, 3803-06. A discussion of these provisions is beyond the scope of this article. For a discussion of Section 162(m), see Part III.A. For a discussion of Section 280G, see Part III.B.

84. See I.R.C. § 162(m) (West 2010); I.R.C. § 280G (West 2010); I.R.C. § 409A (2006); I.R.C. § 4999 (West 2010).

85. See *infra* Part III.

II. INTERPRETING THE CODE TO ADDRESS UNREASONABLE PUBLIC COMPANY COMPENSATION

While the Code has certain objective standards for determining whether compensation paid by a public company is reasonable,⁸⁶ the question may be raised as to whether the tax laws should go further in attempting to limit executive compensation. While numerous articles have previously concluded that the limitation on deductions for a reasonable allowance for compensation applies only to closely held companies,⁸⁷ one commentator has recently called for the Service to step in and regulate executive compensation by unilaterally expanding the scope of its amorphous statutory authority under Section 162(a)(1) to deny deductions for compensation paid to executives of public companies that are not “reasonable” in amount.⁸⁸ In a recently published piece, Aaron Zelinsky argues that the Service has consistently misapplied the statute by failing to treat publicly traded and privately held corporations in a similar manner.⁸⁹

Part IV of this Article provides a further critique of Zelinsky’s views. His argument is incorrect for two reasons. First, as discussed in this Part, such an approach is inconsistent with Congress’ intent in enacting Section 162(a)(1) and its predecessors, the plain meaning of the statute, and prior application of such provisions. Second, as discussed in Part III, past attempts to limit compensation of corporate managers have led to increased executive pay rather than controlling such amounts.

86. See *infra* Part III.

87. See, e.g., Conway, *supra* note 24, at 392; Joy Sabino Mullane, *Incidence and Accidents: Regulation of Executive Compensation Through the Tax Code*, 13 LEWIS & CLARK L. REV. 485, 508-09 (2009); Stabile, *supra* note 24, at 85; Andrew W. Stumpff, *The Reasonable Compensation Rule*, 19 VA. TAX REV. 371, 375-76 (1999); 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, 1676 (2004).

88. See Zelinsky, *supra* note 13, at 638.

89. See *id.*

A. *Section 162(a)(1): Deducting a Reasonable Allowance for Compensation*

The Code provides that “[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.”⁹⁰ This business expense deduction is part of the framework of our tax system, which divides a taxpayer’s expenditures into three categories: business expenses, business expenditures, and personal expenses. Only amounts that fall within the first of these three categories are immediately deductible under Section 162(a).⁹¹ Business expenditures are required to be capitalized, and may only be depreciated or amortized over time in accordance with their useful life or under another method specifically prescribed by the Code.⁹² Personal expenses are generally nondeductible, although certain Code provisions do allow individuals to deduct certain personal expenses.⁹³

Section 162(a)(1) provides one such deductible business expense—a deduction for “a reasonable allowance for salaries or other compensation for personal services actually rendered.”⁹⁴ However, neither the Code nor the Treasury

90. I.R.C. § 162(a) (2006).

91. I.R.C. § 162(a).

92. I.R.C. § 263 (2006); *see, e.g.*, I.R.C. § 167 (West 2010); I.R.C. § 168 (West 2010); I.R.C. § 179 (West 2010); I.R.C. § 195 (West 2010); I.R.C. § 248 (2006); I.R.C. § 709 (2006).

93. I.R.C. § 262 (2006). Professor Marvin Chirelstein notes that:

Business expenses—the costs incurred by the taxpayer in earning gross income—are nondiscretionary in the sense that the income is conditioned on the outlay. Personal expenditures reflect the disposition which the taxpayer elects to make out of the wealth that she has earned. Business expenses must necessarily be deductible if the income tax is to be imposed on “income”; for the same reason, personal expenditures should be disallowed.

MARVIN A. CHIRELSTEIN, *FEDERAL INCOME TAXATION* 103 (11th ed. 2009). Professor Chirelstein also states that “[w]hile the line between business and personal expense is of the essence in all this, the fact is that Congress itself has chosen to cross that line fairly freely by allowing deductions for a variety of items which are plainly personal in nature.” *Id.* at 104.

94. I.R.C. § 162(a)(1). The initial language of Section 162(a) provides a general rule that ordinary and necessary expenses paid or incurred in connection with carrying on a trade or business should be deductible, while at

regulations define what constitutes a “reasonable allowance for salaries or other compensation.”⁹⁵ Rather, whether compensation is reasonable is based on all the facts and circumstances surrounding the payment.⁹⁶ One commentator notes, with disapproval, that “[n]evertheless, the IRS has systematically interpreted § 162(a)(1) to apply only to closely held corporations, effectively concluding that ‘any amount of compensation paid by a publicly held corporation should be per se reasonable,’ even though § 162(a)(1) does not differentiate between the reasonableness of publicly owned and privately held corporations.”⁹⁷

the same time—through the use of the word “including”—provides three specific examples of deductible business expenses. See I.R.C. § 162(a). Although numerous cases stand for the proposition that deductions should be narrowly construed, there is no authority providing that these three examples are all-inclusive. See, e.g., *INDOPCO v. Comm’r*, 503 U.S. 79, 84 (1992); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934); see also *infra* text accompanying notes 138-43.

95. See I.R.C. § 162(a)(1); Treas. Reg. § 1.162-7 (2010). See also Zelinsky, *supra* note 13, at 639 n.8 (“The term ‘reasonable compensation’ is not defined by the tax code or the Treasury regulations.” (quoting Conway, *supra* note 24, at 391)). In addition, Anne Moran notes:

The concept of reasonableness for compensation presents the same types of issues that it does in limiting a reasonable allowance for depreciation or depletion, and in computing the reasonable needs of a business for purposes of the accumulated earnings tax. The concept defies simple interpretation by tax experts in the same manner that the hypothetical reasonable man escapes precise definition by negligence lawyers and the concept of reasonable doubt remains an elusive factor in criminal law.

Anne E. Moran, *Reasonable Compensation*, 390-5th TAX MGMT. PORTFOLIOS (BNA), at A-3 (2011) (footnotes omitted).

96. See *E. Wagner & Son v. Comm’r*, 93 F.2d 816, 818 (9th Cir. 1937).

97. Zelinsky, *supra* note 13, at 639 (quoting Anne E. Moran, *Reasonable Compensation*, 390-4th TAX MGMT. PORTFOLIOS (BNA), at III.B.4 (2009)); see also Conway, *supra* note 24, at 392 (“[Courts] have applied the [§ 162(a)(1)] standard primarily to limit payments by closely held companies where those companies have tried to disguise nondeductible dividends as compensation which would be deductible.”); Stumpff, *supra* note 87, at 377 (“Reasonable compensation cases virtually always involve a fact pattern . . . [with] . . . payments to an employee who is also a shareholder of a closely-held corporation.”); Miske, *supra* note 87, at 1676 (“The concept of reasonableness is primarily intended to stop closely held businesses from artificially increasing employee compensation in an attempt to disburse profits in a deductible form, as opposed to a nondeductible form such as gifts or dividends.”).

Zelinsky is correct in stating that the reasonableness standard traditionally has been applied only to compensation paid by closely held corporations. Case law and legislative history show, however, that his view of the expansive nature of such provision is both erroneous and lacks support.

Prior to the enactment of the Revenue Act of 1913, a similar issue was analyzed under the Payne-Aldrich Tariff Act.⁹⁸ In *United States v. Philadelphia Knitting Mills Co.*, the Third Circuit was confronted with the issue of whether a corporation could be denied a deduction for salary paid to its president on the grounds that such amount was unreasonable.⁹⁹ At the trial court level, the district court ruled that a deduction could not be denied based on the amount paid, but only based upon evidence that the payment was, “in whole or in part, [a] distribution[] of profit[].”¹⁰⁰ The district court ruled for the taxpayer.¹⁰¹ On appeal, the Third Circuit agreed that the government could not, absent statutory authority, inquire into the reasonableness of the compensation paid.¹⁰² The court,

98. Ch. 6, 36 Stat. 11 (1909) (repealed 1913). The Payne-Aldrich Tariff Act of 1909 imposed an excise tax on corporations for the privilege of doing business in corporate form. *See id.* §38, 36 Stat. at 112. The amount of excise tax imposed was measured by corporate income. *Id.*

99. 273 F. 657, 658 (3d Cir. 1921).

100. *Id.* at 657-58.

101. *United States v. Phila. Knitting Mills Co.*, 268 F. 270, 272 (E.D. Pa. 1920).

102. *United States v. Phila. Knitting Mills Co.*, 273 F. 657 (3d Cir. 1921). The court stated that:

Confining our inquiry to the statute, it appears that the basis on which a salary may be allowed as a valid deduction is that it was in fact an “ordinary and necessary expense (of the corporation) actually paid . . . in the maintenance and operation of its business.” . . . Whether services were rendered and whether also they were commensurate with the salary paid are matters of judgment and discretion reposed by general law in the board of directors of the corporation. As the board of directors is charged with the duty and clothed with the discretion of fixing the salaries of the corporation’s officers, the Government has no right (until expressly granted by statute) to inquire into and determine whether the amounts thereof are proper, that is, whether they are too much or too little. But, while the amount of salary fixed by a board of directors is presumptively valid, it is not conclusively so, because the Government may inquire

however, found sufficient evidence existed that the compensation paid was not entirely salary, but rather part of the corporation's profits paid to a shareholder, and remanded the case back to the district court on such grounds.¹⁰³

Both the Revenue Act of 1913 and the Revenue Act of 1916 allowed an unqualified deduction for "ordinary and necessary expenses."¹⁰⁴ Language relating to a deduction for compensation was first added to the statutory lexicon with the enactment of the Revenue Act of 1918.¹⁰⁵ However, the congressional committee reports relating to the 1918 Act shed no light on the rationale for adding this specific reference.¹⁰⁶ Two conflicting arguments have been advanced for this statutory change. The first asserts that the language added in 1918 was intended to limit the business expense deduction, while the other contends that the new language was intended to expand the scope of such deduction.¹⁰⁷

whether the amount paid is salary or something else. . . . It has a right, therefore, to attack the action of a board of directors and show by evidence, not that a given salary is too much, but that, in the circumstances, the whole or some part of it is not salary at all but is profits diverted to a stockholding officer under the guise of salary and as such is subject to taxation.

Id. at 658-59.

103. *Id.* at 659-60.

104. See Moran, *supra* note 95, at A-1 - A-2. See also Revenue Act of 1913, ch. 16, § II(g)(b), 38 Stat. 114, 172 (providing corporations with a deduction for "all the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties . . ."); Revenue Act of 1916, ch. 463, § 12(a), 39 Stat. 756, 762 (providing the same deduction for corporations).

105. Revenue Act of 1918, ch. 18, § 214(a)(1), 40 Stat. 1057, 1066 (1919) (with respect to individuals); Revenue Act of 1918, ch. 18, § 234(a)(1), 40 Stat. at 1077 (1919) (with respect to corporations). Each of these provisions provide a deduction for "[a]ll the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered . . ." Revenue Act of 1918, ch. 18, § 214(a)(1), 40 Stat. at 1066 (1919); Revenue Act of 1918, ch. 18, § 234(a)(1), 40 Stat. at 1077 (1919).

106. See H.R. REP. NO. 1037 (1919), *reprinted in* 1939-1 C.B. (Part 2) 130-67; H.R. REP. NO. 767 (1918), *reprinted in* 1939-1 C.B. (Part 2) 86-117; SEN. REP. NO. 617 (1918), *reprinted in* 1939-1 C.B. (Part 2) 117-130.

107. See Moran, *supra* note 95, at A-1 - A-2.

The argument for a restrictive interpretation for the business expense deduction—i.e., that the Service should impose a “reasonableness” requirement on compensation—looks to the regulations promulgated under the Revenue Act of 1916.¹⁰⁸ The language serving as evidence for such conclusion provides that, with respect to employee bonuses:

If such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered, they will be regarded as a part of the wage or hire of the employee, and therefore an ordinary and necessary expense of operation and maintenance, and as such deductible from gross income.¹⁰⁹

According to one commentator, this regulation proves that the concept of reasonableness in the regulations was intended as a limiting factor reflecting the Service’s desire to police compensation deductions, “particularly in the case of closely held or related taxpayers.”¹¹⁰ “The statutory reasonable compensation clause appears to have been the normal outgrowth of this administrative position.”¹¹¹

A closer analysis of these regulations, and of other regulations promulgated around that time, leads to a different conclusion. While Treasury Regulations promulgated under the Revenue Act of 1913 made no reference to reasonable compensation, such regulations provided that “[a]mounts . . . based upon the stockholdings of such officers or employees, are held to be dividends, and although paid in lieu of salaries or wages, are not allowable deductions from gross income, for the reason that dividends are not deductible.”¹¹² Treasury Regulations promulgated under the Revenue Act of 1916 similarly disallowed a deduction for payments purportedly labeled as salaries through the imposition of a reasonableness test designed to determine whether such amounts were, in reality, disguised dividends.¹¹³ Similarly, the language cited above from these

108. *Id.*

109. Treas. Reg. 33 (Rev.), art. 138 (1918).

110. Moran, *supra* note 95, at A-2.

111. *Id.*

112. Treas. Reg. 33, art. 119 (1914).

113. See Treas. Reg. 33 (Rev.), art. 138 (1918), which provides that:

Salaries of officers or employees who are stockholders will be subject to careful analysis, and if they are found to be out of proportion to the

same regulations in support of imposing a reasonableness requirement on bonuses reads in full as follows:

Special payments, sometimes denominated as gifts or bonuses to employees of corporations, will constitute allowable deductions from gross income in ascertaining net income for the purpose of the income tax, when such payments are made in good faith and as additional compensation for the services actually rendered by the employees. If such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered, they will be regarded as a part of the wage or hire of the employee, and therefore an ordinary and necessary expense of operation and maintenance, and as such deductible from gross income.¹¹⁴

When read in this light, it is clear that the reasonableness of the compensation or bonuses paid to corporate employees should not be determined in the abstract.¹¹⁵ The concept of reasonable compensation was intended solely to distinguish payments of compensation from payments that represented gifts or dividends, and not to impose a requirement that actual payments of compensation be reasonable in order to allow the payor a tax deduction.¹¹⁶ In fact, with respect to gifts and bonuses, rather than limiting the deductibility of payments, the regulations intended to expand their deductibility by reclassifying amounts paid as gifts or bonuses as deductible compensation in situations where such amounts do not exceed a reasonable level of compensation.¹¹⁷ This language does not address amounts already classified as

volume of business transacted, or excessive when compared with the salaries of like officers or employees of other corporations doing a similar kind or volume of business, the amount so paid in excess of reasonable compensation for the services will not be deductible from gross income, but will be treated as a distribution of profits.

114. *Id.*

115. See Note, *The Deduction of a "Reasonable Allowance for Salaries"—The Undefined Power of the Commissioner*, 56 HARV. L. REV. 997, 998 (1943) ("It thus appears that the notion of reasonable allowance was designed to help distinguish compensation payments from gifts, while the distinction between salaries and dividends was made to turn upon the relationship of the payment to the capital invested in the business.").

116. Treas. Reg. 33 (Rev.), art. 138 (1918).

117. *Id.*

compensation. Current regulations also support this reading of prior regulations.¹¹⁸

118. See Treas. Reg. §§ 1.162-7, -8, -9 (1960). In fairness to those that support a narrower view of the reasonable compensation limitation in Section 162(a)(1), Treasury Regulation Section 1.162-7(b)(3) does provide that “[i]n any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances.” However, most of the current regulations relating to the compensation deduction focus on the relationship between the payor and the payee in determining whether such payments should be allowed as a compensation deduction rather than the absolute amount. See, for example, Treasury Regulation Section 1.162-7(b)(1), which provides that:

(b) The test set forth in paragraph (a) of this section and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

In addition, see Treasury Regulation Section 1.162-8, which states that:

The income tax liability of the recipient in respect of an amount ostensibly paid to him as compensation, but not allowed to be deducted as such by the payor, will depend upon the circumstances of each case. Thus, in the case of excessive payments by corporations, if such payments correspond or bear a close relationship to stockholdings, and are found to be a distribution of earnings or profits, the excessive payments will be treated as a dividend. If such payments constitute payment for property, they should be treated by the payor as a capital expenditure and by the recipient as part of the purchase price.

For a regulation focusing on both the relationship between the payor and payee, as well as the amount of the payment, see Treasury Regulation Section 1.162-9, which provides that “[d]onations made to employees and others, which do not have in them the element of compensation or which are in excess of reasonable compensation for services, are not deductible from gross income.”

Professor Erwin Griswold argues for a more expansive business expense deduction, stating that the purpose of the reasonable allowance language "was to enlarge the deduction . . . by allowing a deduction for amounts which had not actually been paid . . ." ¹¹⁹ According to Professor Griswold, "there is no foundation in the statute for [using the reasonable allowance language] as a means of restricting the deduction of amounts which had actually been paid."¹²⁰ Professor Griswold notes that such language first appeared in regulations in order to ease the hardship caused by the Excess Profits Tax of 1917¹²¹ on businesses that paid little or no compensation to its owners/officers-employees.¹²² According to one commentator, Congress later

119. See Erwin N. Griswold, Note, *New Light on "A Reasonable Allowance for Salaries,"* 59 HARV. L. REV. 286, 290 (1945) (emphasis omitted).

120. *Id.*

121. Ch. 159, 39 Stat. 1000.

122. See Treas. Reg. 41, art. 39 (1918); Griswold, *supra* note 119, at 288-89. With respect to individuals, these regulations provided that:

An individual carrying on a trade or business having an invested capital may in computing the net income of the trade or business for purposes of the excess profits tax deduct a reasonable amount designated by him as salary or compensation for personal service actually rendered by him in the conduct of such trade or business. In no case shall the amount so designated be in excess of the salaries or compensation customarily paid for similar service under like responsibilities by corporations or partnerships engaged in like or similar trades or businesses.

Treas. Reg. 41, art. 32 (1918). Additionally, regulations provided that partnerships could deduct reasonable salaries or compensation paid to individual partners for personal services actually rendered during the taxable year if the payment were made in accordance with prior agreements and were properly recorded on the books of the partnership. See *id.* Similar relief from the Excess Profits Tax was provided to closely held corporations through a Treasury Department publication. See Griswold, *supra* note 119, at 288 (citing OFFICE OF THE COMM'R OF INTERNAL REVENUE, U.S. TREASURY DEP'T, EXCESS PROFITS TAX PRIMER ¶ 51 (1918)). The Excess Profits Tax Primer provided:

51. A corporation in which most of the stock is owned by its officers has in the past voted to its officers only nominal salaries as drawing accounts. In computing net income for purposes of the excess-profits tax may the corporation deduct as items of expense amounts which would constitute reasonable compensation for the services actually rendered by its officers?

Yes, if a satisfactory explanation is given. For any period prior to March 1, 1918, reasonable salaries for services actually rendered may

incorporated the reasonable compensation clause in the Revenue Act of 1918 in order to furnish a statutory basis for the relief granted by these regulations.¹²³ Case law and administrative pronouncements similarly support this view.¹²⁴

The Board of Tax Appeals, however, interpreted the new language found in the Revenue Act of 1918 to be a mandate to inquire into the reasonableness of compensation actually paid.¹²⁵ This interpretation found approval with the courts.¹²⁶ The interpretation is incorrect, though, when

be deducted, even though the full amounts had not been formally voted as salaries by the corporation.

EXCESS PROFITS TAX PRIMER, *supra*, ¶ 51.

123. See Moran, *supra* note 95, at A-2; see also Griswold, *supra* note 119, at 288 (noting that the language of the Revenue Act of 1918 and the previous administrative authorities were “essentially the same”).

124. In *Appeal of Gottlieb Bros.*, 1 B.T.A. 684 (1925), the Board of Tax Appeals relied on Treasury Regulation 41, Article 39 to allow a partnership deduction for reasonable salaries for services rendered even though such salaries were never paid. The Board concluded that:

The regulation quoted seems to us reasonable and proper in the light of the whole intent and purpose of Title II of the Revenue Act of 1917. It certainly does justice where a strict application of the letter of the statute would do grave injustice. It has been regularly and consistently applied by the Commissioner from its promulgation in 1917 until at least as recently as February, 1924 (A.R.R. 6087, C.B. III-1, 128).

Gottlieb Bros., 1 B.T.A. at 686. In A.R.R. 6087, III-1 C.B. 128 (1924), the Board of Tax Appeals concluded that a partnership was entitled to deduct a reasonable amount for partners' salaries for services even though no such payments had actually been made. The Board, in discussing the regulations, noted that the intent and purpose when drafting the regulations was to “recognize the unfortunate and inequitable position in which many partnerships had been placed by the advent of the excess-profits tax in 1917 without having had any previous income tax history or experience to guide them in the adjustment of their affairs so as to secure equitable salary deductions.” *Id.* at 129. The Board went on to note “it has been the practice of the Income Tax Unit to allow a reasonable amount for partners' salaries . . . even though none were actually paid and no agreement existed for payment thereof.” *Id.*

125. See Moran, *supra* note 95, at A-2.

126. See *id.* (citing *Lucas v. Ox Fibre Brush Co.*, 281 U.S. 115 (1930); *Gustafson Mfg. Co. v. Comm'r*, 1 B.T.A. 508 (1925)). In *Gustafson*, the court concluded that the compensation paid to the majority shareholder of a close corporation was not reasonable. 1 B.T.A. at 510. In so holding, however, the court did not distinguish between the compensation paid by a close corporation to a shareholder and compensation paid to persons who were not also

viewed in light of both the Congress' intent in revising the statute and the statutory language.

B. *A Reasonable Allowance for Compensation Is Different Than Reasonable Compensation*

Having previously discussed Congress' intent behind the 1918 addition of a deduction for a reasonable allowance for compensation,¹²⁷ an exploration into the literal language of the statute is warranted. The Code does not specifically enumerate a deduction for reasonable compensation. Rather, Section 162(a) provides that "[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including . . ."¹²⁸ Section 162(a)(1), which forms a part of this provision, permits a deduction for a "reasonable allowance for salaries or other compensation for personal services actually rendered."¹²⁹ By analyzing the statutory construction of Section 162(a), two distinct arguments develop. First, a deduction for a reasonable allowance for compensation is different than a deduction for reasonable compensation. Second, the language "including" should not be read as limiting.

Only three Code sections use the term "reasonable allowance" in determining the amount of a deduction to which a taxpayer is entitled.¹³⁰ All other Code provisions allowing taxpayers a deduction, including the general

shareholders. According to the court, "[u]nder the provision of this section the Commissioner not only has the authority but it is his duty to determine under all the facts obtainable the reasonableness or unreasonableness of deductions by a corporate taxpayer of compensation paid." *Id.*

127. See *supra* text accompanying notes 112-24.

128. I.R.C. § 162(a) (2006).

129. I.R.C. § 162(a)(1).

130. Section 162(a)(1) provides the deduction for a reasonable allowance for compensation for services actually rendered. I.R.C. § 162(a)(1). Section 167 allows a depreciation deduction for a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in a trade or business or held for the production of income. I.R.C. § 167(a) (2006). Section 611(a) provides a reasonable allowance for depletion in the case of certain natural resources. I.R.C. § 611(a) (2006).

business expense deduction of Section 162(a), require that actual amounts be paid, incurred, or sustained.¹³¹

In understanding the meaning behind such phrase, a few principles of statutory construction are relevant. First, “reasonable allowance” is a term of art, and should be afforded the general understanding given such term.¹³² Second, as a matter of statutory construction, where the same phrase is used in one or more related statutes, it should be accorded the same meaning.¹³³ Finally, where a different phrase is used in similar statutes, it should be accorded a different meaning.¹³⁴

Although the term “reasonable allowance” is used as a term of art in the Code and in tax parlance, not much is written about its meaning. However, where the term is used, it is generally presumed to mean an estimated, rather

131. *See, e.g.*, I.R.C. § 163(a) (West 2010) (providing a deduction for interest paid or accrued during the taxable year); I.R.C. § 164(a) (West 2010) (allowing a deduction for taxes paid or accrued during the taxable year); I.R.C. § 165(a) (2006) (providing a deduction for losses sustained during the year); I.R.C. § 170(a) (2006) (allowing taxpayers to deduct charitable contributions made or, in the case of corporations on the accrual method of accounting, deemed made during the year); I.R.C. § 213 (2006) (allowing a deduction for medical expenses paid during the year not compensated for by insurance or otherwise); I.R.C. § 215 (2006) (providing a deduction for actual amounts of alimony or separate maintenance paid during the year).

132. YULE KIM, CONG. RESEARCH SERV., 97-589 STATUTORY INTERPRETATION: GENERAL PRINCIPLES AND RECENT TRENDS 6 (2008). Kim states that:

[W]here Congress borrows terms of art in which are accumulated the legal tradition and meaning of centuries of practice, it presumably knows and adopts the cluster of ideas that were attached to each borrowed word in the body of learning from which it was taken and the meaning its use will convey to the judicial mind unless otherwise instructed. In such a case, absence of contrary direction may be taken as satisfaction with widely accepted definitions, not as departure from them.

Id. (quoting *Morissette v. United States*, 342 U.S. 246, 263 (1952) (Jackson, J.)).

133. *See id.* at 13 (“A term appearing in several places in a statutory text is generally read the same way each time it appears.” (quoting *Ratzlaf v. United States*, 510 U.S. 135, 143 (1994))).

134. *Id.* at 14 (“[W]here Congress includes particular language in one section of a statute but omits it in another . . . , it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion.” (quoting *Keene Corp. v. United States*, 508 U.S. 200, 208 (1993))).

than an actual, amount.¹³⁵ Congress' decision, then, to allow a deduction for a reasonable allowance for compensation rather than a deduction for reasonable amounts of compensation is significant. As a matter of statutory construction, the term "reasonable allowance" found in Section 162(a)(1) should be read in a manner similar to the same term in Section 167—as a deduction for an estimated amount—and should be distinguished from other provisions that allow a deduction for actual amounts.¹³⁶ This is

135. See, for example, J.S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS, 1938-1861, at 968 (1938), where the legislative history to the Revenue Act of 1916 provides an interesting discussion of the meaning of such term in the context of the deduction for a reasonable allowance for actual reduction in flow and production in the case of oil and gas wells. In that discussion, Senators Lane and Williams argue the method of calculating such reasonable allowance. Senator Lane concludes that the amount is an estimate that is "merely arbitrary." *Id.* In determining the deduction for traveling expenses under Section 162(a)(2), the Service permits taxpayers to take a deduction for a "per diem" (i.e., a standard allowance) for lodging, meals and automobile mileage. See INTERNAL REVENUE SERV., PUB. 463, TRAVEL, ENTERTAINMENT, GIFT, AND CAR EXPENSES 4-7 (2011). Although the Service never defines the term "per diem," a commonly accepted definition for such term is as follows:

The meal per diem is a reasonable allowance for meals and incidental expenses for the area. It is not intended to be a reimbursement for actual expenses but rather a reasonable allowance. Some travelers may spend more than the amount for personal travel expenses while others may spend less than the M&IE per diem but the principle behind the per diem is that it is a reasonable amount to cover the traveler's necessary expenses.

Controller's Office, *Procedure 20335c: Meals & Incidental Expenses*, VIRGINIA TECH, <http://www.co.vt.edu/Procedures/p20335c.html> (last visited Apr. 15, 2011). For an example of the use of the term "reasonable allowance" outside of tax law, see Kansas Statute section 50-645(c), which provides that "a reasonable allowance for the consumer's use of the vehicle" is not an actual amount but an estimate based on a publication by the American Automobile Association. KAN. STAT. ANN. § 5-645(c) (2011). A Minnesota statute provides an expense allowance for members of governmental boards or agencies set as "a reasonable allowance for expenses or a per diem allowance in lieu of expenses." MINN. STAT. § 375.47 (2010).

136. In discussing the deductibility of intangibles under a "reasonable allowance" standard, the Supreme Court has noted that:

[S]ince 1918, at least some intangible assets have been depreciable. Because intangible assets do not exhaust or waste away in the same manner as tangible assets, taxpayers must establish that public taste or other socioeconomic forces will cause the intangible asset to be

especially true in light of the history explaining that the deduction for a “reasonable allowance” for compensation was intended to allow taxpayers to estimate the amount that would or should have been paid by a closely held business had salaries been paid to the owners-officers through an arms-length negotiation in order to alleviate the burden of the Excess Profits Tax.¹³⁷

retired from service, and they must estimate a reasonable date by which this event will occur.

Newark Morning Ledger Co. v. United States, 507 U.S. 546, 556 (1993) (citing BORIS I. BITTKER & MARTIN J. MCMAHON, JR., FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 12.4 (1988)). In cases where Congress has determined what a “reasonable allowance” is, it has enacted legislation specifying what constitutes reasonable. *See, e.g.*, I.R.C. § 197 (2006) (enacted in response to *Newark Morning Ledger* to provide a fifteen year period for amortizing certain intangibles); I.R.C. § 168 (West 2010) (providing specific guidance with respect to the methodology for depreciating tangible property); I.R.C. § 195 (West 2010) (providing a fifteen year amortization period for start-up expenditures); I.R.C. § 248 (2006) (providing a 180 month amortization period for corporate organizational expenditures); I.R.C. § 709 (2006) (same for partnership organizational expenditures).

137. *See supra* text accompanying notes 119-24. Professor Griswold also notes:

Then there are the words “reasonable allowance” for services “actually rendered.” These have never quite fitted the Treasury’s recent construction of the phrase as a limiting provision. But they are quite natural once it is realized that the phrase is an enlarging provision, allowing the deduction of amounts although they have not actually been paid. For, since there is not an actual payment to determine the amount of such a deduction, there must be some limit or measure, and this was expressed as a “reasonable allowance,” with the further limitation that the allowance could be made only for services “actually rendered.” With this new light on the background of the provision, it is apparent that it has no bearing on the deduction of salary payments actually made, and furnishes no proper basis for the disallowance of any deduction. This view is confirmed by the fact that the language was not in fact used by the Treasury as a limitation on the deductibility of salaries for many years after it was enacted—during all of the period when the persons who were familiar with its origin and purpose were still in office.

Griswold, *supra* note 119, at 290.

C. *Reasonableness Should Not Be a Limiting Factor in Determining Deductibility of Actual Compensation*

Once it is settled that a reasonable allowance for compensation refers to an estimated amount, the issue remains whether a deduction is allowed for actual compensation paid regardless of its reasonableness. The answer should be yes. The Code provides a deduction for “all” the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business.¹³⁸ These words are followed by three specific deductions which are added to Section 162(a) through the use of the word “including.”¹³⁹ The term “including” is a nonexclusive term that is intended to introduce examples.¹⁴⁰ The specific examples found in Section 162 are illustrative of situations that depart from the provision’s general rules and require additional explanation. This Article has already discussed why a deduction for an estimated amount of compensation is different from other deductions for amounts paid.¹⁴¹ The paragraph allowing a deduction for traveling expenses provides a limitation that such expenses must be incurred by a taxpayer “while away from home in the pursuit of a

138. I.R.C. § 162(a) (2006).

139. I.R.C. § 162(a).

140. See M. DOUGLASS BELLIS, FED. JUDICIAL CTR., STATUTORY STRUCTURE AND LEGISLATIVE DRAFTING CONVENTIONS: A PRIMER FOR JUDGES (2008), which states:

It has become a convention in federal law that the term “including” means what it usually means in English. It is a nonexclusive “for instance” type of phrase. If I say I have some change in my pocket, including a penny and a dime, most people would expect that I might have some other coins as well. Few would think I meant to exclude that possibility. But in legal writing in general, there seems a worry that “including” means that what follows is a complete list of the elements. There are even a few federal laws that use the term “including but not limited to.” The “but not limited to” should be thought of as surplusage.

Id. at 11. In the context of the deduction for a reasonable allowance for compensation, see Griswold, *supra* note 119, at 290, which states that “[t]here is first the word ‘including,’ which has never made sense as the introduction to a restrictive phrase.”

141. I.R.C. § 162(a)(1); *see supra* Part II.B.

trade or business.”¹⁴² The third enumerated deduction, the deduction for rental payments, is similarly limited—only those payments that are for property in which the taxpayer does not have or is not taking an equity interest are deductible.¹⁴³

In other words, to be deductible a business expenses must meet the requirements of Section 162(a) and not be disallowed or restricted under another provision of the Code (including the restrictions and limitations applicable to those expenses specifically enumerated in Section 162(a)). As discussed previously, capitalized expenditures and personal expenses are not deductible.¹⁴⁴ Only those expenses that are considered customary, ordinary, or usual are deductible under Section 162(a).¹⁴⁵ Accordingly, the question is whether compensation paid by a corporation is customary, ordinary, or usual, or whether the deduction for such amount is qualified by a reasonable standard.¹⁴⁶

Most commentators would argue that compensation must be reasonable to be deductible, and, that while the Service has generally applied this standard only to closely held corporations, this reasonableness requirement similarly could be applied to public corporations.¹⁴⁷ This

142. I.R.C. § 162(a)(2). In addition, as stated previously, the deduction for travel expenses allows taxpayers to use an estimated amount in determining the size of the deduction. *See supra* note 135.

143. I.R.C. § 162(a)(3).

144. *See supra* text accompanying notes 92-93.

145. *See Deputy v. Dupont*, 308 U.S. 188, 195 (1940).

146. Compensation that does not satisfy the “ordinary and necessary” standard of Section 162(a) should not be deductible. In this vein, compensation intended to pay an employee for future services spanning several years would not be ordinary and, accordingly, should be capitalized. Similarly, compensation paid to provide services not related to a trade or business should be found not to be necessary and, therefore, nondeductible.

147. Mullane, *supra* note 87, at 510 n.90 (“Most commentators agree that the statutory language of 162(a)(1) would support challenges of executive compensation levels, even in public companies.” (citations omitted)); *see also* Edward A. Zelinsky, *The Tax Policy Case for Denying Deductibility to Excessive Executive Compensation: Disguised Dividends, Reasonable Compensation, and the Protection of the Corporate Income Tax Base*, 58 TAX NOTES 1123, 1124 (1993) (“The code’s restriction on the deductibility of compensation to reasonable, i.e., arm’s length, levels literally applies to all corporations; in practice, however, the IRS and the courts have invoked section 162(a)(1) only as

author believes, however, that the Service has not applied a reasonableness standard to determine whether compensation is deductible,¹⁴⁸ but rather that the Service has used a reasonableness criterion to differentiate those payments that are deductible business expenses from disguised dividend payments made to shareholders in an attempt to avoid the imposition of a corporate level tax.¹⁴⁹ In so doing, the Service generally has correctly limited its analysis of the reasonableness of employee compensation to payments made to shareholders of closely held corporations.

This conclusion—that the Service uses a reasonableness standard as a mechanism for uncovering nondeductible shareholder distributions disguised as deductible

to closely held corporations, and Congress apparently has acquiesced in this long-standing application of the reasonable compensation rule.”); Edward A. Zelinsky, *Reasonable Compensation: A Study in Doctrinal Obsolescence* 10 (Cardozo Law Sch. Working Paper Series No. 31, 2000), available at <http://papers.ssrn.com/sol3/papers.cfm?abstract.id=254928> (“Nothing in the statute limits the test of reasonability to closely-held corporations or otherwise supports the IRS’s de facto interpretation of Section 162(a)(1) as constraining only closely-held corporations.”). But see Bernard Wolfman, *Professors and the “Ordinary and Necessary” Business Expense*, 112 U. PA. L. REV. 1089 (1964), where Professor Wolfman notes:

Section 162(a)(1) (“reasonable allowance for salaries”) has been thought to provide special warrant for the disallowance as “unreasonable” of excessive salary payments. But the fact is—and should be recognized and stated—that salary payments are disallowed when they are found to be for something other than services, *e.g.*, to cover a living or hobby expense of a shareholder-employee or just a “salary” so much in excess of competitive requirements that it is recognized as a distribution to a shareholder-employee of corporate earnings. Literal subservience to a presumed requirement of “reasonableness” has led, however, to wholly unjustified disallowance in an arm’s-length employer-employee situation . . . and ignores legislative history.

Id. at 1115 n.97 (citations omitted).

148. *But see* Barbara F. Sikon, Note, *The Recharacterization of Unreasonable Compensation: An Equitable Mandate*, 51 CLEV. ST. L. REV. 301, 305 (2004). (“The purpose of section 162 is to allow employers to deduct salary payments that are reasonable. Conversely, deductions for unreasonable salary payments must be disallowed.”).

149. *See id.* at 303 (“The deduction limitation of section 162 has been applied historically in a manner that illuminates a singular purpose, that is, to unveil payments of a noncompensatory nature that have been disguised as compensation to create a tax benefit.” (citing Stumpff, *supra* note 87, at 380)).

compensation—is supported by two factors. First, the case law surrounding Section 162(a)(1) is replete with cases involving payments made by closely held corporations to related persons but lacking of cases involving public corporations.¹⁵⁰ As one commentator notes, it is not unnatural for reasonable compensation cases to arise in the case of payments between a closely held corporation and either a shareholder or a shareholder's relative: compensation is a deductible expense, while neither dividends nor gifts are deductible in computing a corporation's taxable income.¹⁵¹ In fact, thousands of cases have been decided analyzing the reasonableness of compensation in the closely held corporation.¹⁵² “Less appreciated, however, is the nearly complete absence of decisions denying a deduction where a truly arm's-length relationship existed between the employer and employee.”¹⁵³

150. See *id.*, where Sikon states:

The intent of the restriction to reasonableness of section 162, to unveil noncompensatory payments disguised as compensation, is supported both by 1) the consistency with which section 162 has been applied to payments to related parties in closely-held businesses, and 2) the notable absence of cases involving payments made by large, publicly-traded corporations. Although large corporations can make excessive salary payments, they are not attacked through section 162(a) because the character of the payments as compensation is not subject to dispute. The excessive payments lack the potential to be reclassified as dividends due to the strict uniformity of dividend payments made by a publicly-held corporation Challenges through section 162(a) have been reserved for closely held businesses, in which the owner can determine both the amounts and the characterizations of payments to employees. This attests to the function of section 162(a) as a vehicle to scrutinize the proper characterization of a transaction.

Id. at 308.

151. Stumpff, *supra* note 87, at 377.

152. *Id.* (citing Gerald A. Kafka, *Reasonable Compensation*, 390-2d TAX MGMT. PORTFOLIO (BNA), at A-5 (1993)). Stumpff notes that “[t]he ‘reasonable compensation’ issue ranks among the most frequently litigated of all tax questions.” *Id.* at 372-73 n.4 (citing U.S. GOV'T ACCOUNTABILITY OFFICE, GAO/GGD-95-232, TAX ADMINISTRATION: RECURRING ISSUES IN TAX DISPUTES OVER BUSINESS EXPENSE DEDUCTIONS 15-17 (1995)).

153. *Id.* at 377-78 (emphasis omitted). Stumpff cites only a single case in which a payment by a corporation to a person unrelated to a corporation's shareholders was recharacterized as other than compensation. *Id.* at 377-78 (citing *Patton v. Comm'r*, 168 F.2d 28 (6th Cir. 1948)). While the facts of *Patton*

This author has found no cases in which the Service has successfully challenged the reasonableness of compensation paid by a public company.¹⁵⁴

do not indicate an attempt by the shareholders to recharacterize a nondeductible amount into compensation, Stumpff states that “[e]ven in *Patton* . . . the relationship among the parties was likely something less than completely arm’s-length.” *Id.* at 378 (citing Kafka, *supra* note 152, at A-5); *see also* Sikon, *supra* note 148, at 308 (“In *Patton*, the party to whom unreasonable payments were made was neither an owner nor a relative of an owner, but rather an elderly, favored employee. Although he was not a related party in the sense of actual family, a strong personal relationship that evolved over many years of employment made the transaction less than arms’ length.”). In *Patton*, the dissent analyzed the history of the Service’s inquiry into the reasonableness of compensation paid by a corporation noting that, where a deduction was disallowed:

In all of these cases, the amounts were paid to officers who were really the beneficial owners of the corporation and who controlled its action in contracting for and paying them the unusually high salaries based upon net profits. The reasons the courts have held such salaries were not deductible as “ordinary and necessary expenses,” were because they were not, in fact, compensation . . . but profits diverted to stock holding officers under the guise of salaries; and that a distribution of profits “under the guise of salaries” to officers who held the stock of a company and controlled its affairs, is not an ordinary and necessary expense, within the meaning of the statute

. . . As was said in *United States v. Philadelphia Knitting Mills Co.*, *supra*, the Government has no right to inquire into and determine whether the amount of the salary was proper, or whether it was too much or too little, but only “whether the amount paid is salary or something else.”

Patton, 168 F.2d at 33 (quoting *United States v. Phila. Knitting Mills Co.*, 273 F. 657, 658 (3d Cir. 1921) (McAllister, J., dissenting)).

154. Professor Stabile provides four cases in which the Service challenged the reasonableness of compensation paid by a public corporation. *See* Stabile, *supra* note 24, at 85 & n.14. In two of these cases, the compensation paid was found to be reasonable and the taxpayer was allowed the deduction. *See* *Brown-Forman Distillers Corp. v. United States*, 132 F. Supp. 711 (Ct. Cl. 1955); *Pfeifer Brewing Co. v. Comm’r*, 11 T.C.M. (CCH) 586 (1952). The third case, *R.J. Reynolds Tobacco Co. v. United States*, 149 F. Supp. 889 (Ct. Cl. 1957), *aff’d*, 260 F.2d 9 (4th Cir. 1958), was “not so much an issue of excessive compensation as it was a claim that the method for allocating stock under a bonus arrangement made the stock distribution more like a dividend than a compensation payment.” Stabile, *supra* note 24, at 85 n.14 (citing *R.J. Reynolds*, 149 F. Supp. at 12). The final case, *Patton*, “involved a suspicion that the employer and not the employee actually kept the compensation.” Stabile, *supra* note 24, at 85 n.14 (citing *Patton*, 168 F.2d at 29). For a discussion of *Patton*, *see supra* note 153.

Second, the Service has attempted to apply a reasonableness standard to compensation paid by S corporations only in situations where an adjustment to the amount treated as compensation would result in a tax adjustment.¹⁵⁵ Since a taxpayer that is both the owner and an employee of an S corporation can receive corporate distributions either in the form of salary or dividend distributions, taxpayer gamesmanship in characterizing payments as either the former or the latter can result in the shareholder-employee receiving the same economics at the expense of the fisc. In this context, the Service has challenged the reasonableness of compensation in two circumstances: first, in situations where the compensation was unreasonably high; second, in situations where the compensation is unreasonably low.¹⁵⁶

With respect to excessive compensation, the Service had challenged the reasonableness of compensatory payments in

But see I.R.S. Priv. Ltr. Rul. 7735027 (May 31, 1977), where, without reaching a conclusion on the question of fact, the Service noted that Section 162(a)(1) allows a deduction for compensation that is reasonable in amount and for services actually rendered. *Id.* The taxpayer at issue in the private letter ruling was a publicly traded corporation. *Id.* However, even in such situation, the facts indicate that the compensation arrangement was connected to a potential repurchase of the stock of the corporate executives. *Id.* The Service concluded the ruling by stating that,

[I]t is held that the payments made by M to A and B in accordance with the agreements described above are deductible by M as compensation under section 162 of the Code to the extent that such payments when added to all other compensation paid by M to A and B, are reasonable in amount and for services actually rendered by A and B to M. The question of whether such payments are, in fact, reasonable in amount and for services actually rendered, rather than for the stock of N, which A and B agreed to sell to M are questions of fact to be determined upon audit by the appropriate office of the District Director.

Id.

155. See Sikon, *supra* note 148, which states:

The incidence of section 162 challenges to subchapter S corporation payments are relatively infrequent and limited to special situations in which there is a potential tax increase accompanying an adjustment. . . . That is, due to the lack of inherent double taxation applicable to C corporation dividends, an S corporation owner has no tax avoidance purpose to achieve by overcompensating himself or other owners.

Id. at 308-09 (footnote omitted).

156. *Id.* at 310.

situations in which the payment of excessive compensation would have resulted in tax avoidance as a result of the difference in tax rates for earned and unearned income of S corporation shareholders.¹⁵⁷ Between 1971 and 1981, Section 1348 provided for a maximum marginal tax rate of fifty percent on earned income at a time when the highest marginal rate on unearned income was seventy percent.¹⁵⁸ During that period, the Service challenged the reasonableness of compensation to determine whether the owners of S corporations were paying excessive compensation in an attempt to convert unearned income into earned income.¹⁵⁹

Below-market compensation, on the other hand, allows a shareholder-employee to avoid payroll tax liabilities.¹⁶⁰ In

157. *Id.*

158. Section 1348 was added to the Code by the Tax Reform Act of 1969, Pub. L. 91-172, § 804(a), 83 Stat. 487, 685 (effective for tax years beginning December 31, 1970). Section 1348 was repealed effective for tax years beginning after December 31, 1981. See Economic Recovery Act of 1981, Pub. L. No. 97-34, § 101(c)(1), 95 Stat. 172, 183.

159. See, for example, *RTS Investment Corp. v. Commissioner*, 877 F.2d 647 (8th Cir. 1989), where in upholding the lower court's determination that salaries paid to a corporation's shareholders were not reasonable in amount, the court stated that "the burden of proving reasonableness of compensation is on the taxpayer and 'close scrutiny' is required of salary arrangements between a corporation and its shareholders." *Id.* at 650 (citations omitted). See also *Hilt v. Comm'r*, 899 F.2d 1225, No. 88-7331, 1990 WL 42264 (9th Cir. 1990) (unpublished table decision); *Chi. Stadium Corp. v. United States*, No. 88 C 3706, 1991 WL 185227, at *8 (N.D. Ill. June 21, 1991) ("[T]he payment must be made for services rendered to the corporate employer and not for something else—whether a dividend distribution or anything else—in disguise."). For cases upholding the taxpayer's determination of a reasonable amount of compensation, see *Trucks, Inc. v. United States*, 588 F. Supp. 638, 642 (D. Neb. 1984), *aff'd*, 763 F.2d 339 (8th Cir. 1985) ("[C]ompensation paid to employee-shareholders by closely held corporations are subject to careful scrutiny in order to insure that what is really a distribution of dividends may not be passed off as a payment of compensation."); *Wigutow v. Comm'r, T.C.M. (P-H) ¶ 83,620* (1983); *Schiff v. Comm'r*, 41 T.C.M. (CCH) 659 (1980) ("Where officer-shareholders, who are in control of a corporation, set their own compensation, careful scrutiny is required to determine whether the alleged compensation is in fact a distribution of profits.").

160. See I.R.C. § 3111 (2006) (subjecting wages, but not dividends, to the Social Security and Medicare excise taxes). See also *Construction & Design Co. v. United States Citizenship and Immigration Services*, 563 F.3d 593 (7th Cir. 2009), in which the court notes that:

those cases, the Service has attempted to recharacterize dividends paid by an S corporation as compensation subject to payroll taxes.¹⁶¹ For example, in *Radtke v. United States*, the court held that a lawyer who worked full-time for his wholly owned professional S corporation and drew no salary would be subject to employment taxes on dividends withdrawn from the corporation.¹⁶² In analyzing the case before it, the court noted that it was obligated “to look at the substance, not the form, of the transactions at issue[.]”¹⁶³ and that, determining whether dividends could be recharacterized as wages where the amount of wages paid were unreasonably low, “is simply the flip side of those instances in which corporations attempt to disguise profit distributions as salaries for whatever tax benefits that may produce.”¹⁶⁴

The distinction between accounting profits, losses, assets, and liabilities, on the one hand and cash flow on the other is especially important when one is dealing with either a firm undergoing reorganization in bankruptcy or a small privately held firm; in the latter case, in order to avoid double taxation (corporate income tax plus personal income tax on dividends), the company might try to make its profits disappear into officers’ salaries. See *Menard, Inc. v. Commissioner*, 560 F.3d 620, 621 (7th Cir. 2009). The owners of a Subchapter S corporation, however, have the opposite incentive—to alchemize salary into earnings. A corporation has to pay employment taxes, such as state unemployment insurance tax and social security tax, on the salaries it pays. A Subchapter S corporation can avoid paying them by recharacterizing salary as a distribution of corporation income.

Id. at 595-96. This issue plagued John Edwards during the 2004 presidential campaign. See Laura Saunders, *The Unforeseen Risks of Underplaying Your Income*, WALL ST. J., Feb. 5, 2011, at B9.

161. See, e.g., Rev. Rul. 74-44, 1974-1 C.B. 287.

162. 712 F. Supp. 143 (E.D. Wis. 1989), *aff’d per curiam*, 895 F.2d 1196 (7th Cir. 1990).

163. *Id.* at 145 (citing *Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1978)).

164. *Id.* at 146 (citing *Miles-Conley Co. v. Comm’r*, 173 F.2d 958, 960-61 (4th Cir. 1949)). See also *David E. Watson, P.C. v. United States*, 714 F. Supp. 2d 954 (S.D. Iowa 2010), which cites cases dealing with the substance over form doctrine to analyze whether dividends paid by an S corporation to its sole shareholder who was also an employee constituted compensation subject to employment tax. *Id.* at 963-64. The court denied the taxpayer’s motion for summary judgment. *Id.* at 966. The court later held that the Service’s

As these S corporation cases show, the Service's concern is not with the level of compensation paid to an S corporation shareholder, but, rather, whether an employee-shareholder is using the corporate form and the labels surrounding the payment (i.e., as compensation or corporate distribution) in order to avoid the incurrence of taxation.

III. CURRENT TAX PROVISIONS THAT ATTEMPT TO REGULATE EXECUTIVE COMPENSATION

Currently, four different Code provisions act to limit executive compensation. First, unless certain exceptions apply, Section 162(m) prevents publicly traded corporations from deducting compensation paid to certain corporate officers in excess of \$1 million.¹⁶⁵ Second, Sections 280G and 4999 operate in tandem in an attempt to penalize publicly traded corporations that pay golden parachute payments and the employees that receive such payments.¹⁶⁶ Finally, Section 409A provides rules governing the tax treatment of nonqualified deferred compensation.¹⁶⁷ More specifically, under Section 409A, unless certain requirements are satisfied, amounts deferred under a nonqualified deferred compensation plan are currently includible in income to the extent not subject to a substantial risk of forfeiture.¹⁶⁸ Section 409A merely imposes timing rules, and has no impact on the amount of compensation the employer can pay or deduct.¹⁶⁹ Because Section 409A neither limits itself to the compensation paid by publicly traded corporations, nor effects the amount or deductibility of such compensation, this Part focuses on Sections 162(m), 280G, and 4999.

recharacterization of dividend and loan payments to the taxpayer as wages was reasonable. *See id.* at 963.

165. I.R.C. § 162(m) (West 2010). *See infra* Part III.A.

166. I.R.C. § 280G (West 2010); I.R.C. § 4999 (2006). *See infra* Part III.B.

167. I.R.C. § 409A (2006).

168. I.R.C. § 409A(a).

169. *See* William A. Drennan, *The Pirates Will Party On! The Nonqualified Deferred Compensation Rules Will Not Prevent CEOs From Acting Like Plundering Pirates and Should Be Scuttled*, 33 VT. L. REV. 1, 27 (2008).

A. *Section 162(m)*

In 1993, Congress enacted Section 162(m) in an attempt to deal with the perceived problem of excessive executive compensation.¹⁷⁰ Executive compensation was of significant interest to the media during the early 1990s, and, in particular, during the 1992 presidential campaign.¹⁷¹ The legislative history states that Section 162(m) was motivated by concerns regarding the amount of executive compensation paid by public companies, and that the provision was intended to reduce excessive compensation.¹⁷² According to a House report, “the amount of compensation received by corporate executives has been the subject of scrutiny and criticism.”¹⁷³ Congress determined that “excessive compensation will be reduced if the deduction for compensation (other than performance-based compensation) paid to the top executives of publicly held corporations is limited to \$1 million per year.”¹⁷⁴

170. See Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13211(a), 107 Stat. 312, 469-71; see also Conway, *supra* note 24, at 396.

171. See Conway, *supra* note 24, at 396; Kevin J. Ryan, *Rethinking Section 162(m)'s Limitation on the Deduction of Executive Compensation: A Review of the Commentary*, 15 VA. TAX REV. 371, 371 (1995); Kenneth R. Ferris & James S. Wallace, I.R.C. Section 162(m) and the Law of Unintended Consequences (Nov. 2006) (unpublished manuscript), available at <http://ssrn.com/abstract=942667>. During the 1992 presidential campaign, then-Governor Bill Clinton stated that “[i]t’s wrong for executives to do what so many did in the 1980s. The biggest companies raised their [executives’] pay four times the percentage their workers’ pay went up and three times the percentage their profits went up.” *The Bureau of Nat’l Affairs, Presidential Candidates Divide on Executive Compensation Caps*, 24 Sec. Reg. & L. Rep. (BNA) 42, 1634 (1992).

172. See STAFF OF J. COMM. ON TAXATION, 109TH CONG., PRESENT LAW AND BACKGROUND RELATING TO EXECUTIVE COMPENSATION 6 (Comm. Print 2006) [hereinafter 2006 JCT EXECUTIVE COMPENSATION REPORT] (citing H.R. REP. NO. 103-111, at 646 (1993)); see also Camelia M. Kuhnlen & Alexandra Niessen, *Is Executive Compensation Shaped by Public Attitudes?* (Oct. 2009) (unpublished manuscript), available at <http://ssrn.com/abstract=1328572> (providing preliminary evidence that the increased negativity and media coverage of CEO pay between 1990 and 1992 led to the passage of Section 162(m)).

173. H.R. REP. NO. 103-111, at 646.

174. *Id.* The Conference Committee Report specifically states that Section 162(m) was not intended to “modify the present-law requirement that in order to be deductible compensation must be reasonable.” H.R. REP. NO. 103-213, at 584 n.44 (1993) (Conf. Rep.). The Staff of the Joint Committee on Taxation has

Section 162(m) denies a deduction for applicable employee remuneration¹⁷⁵ paid or accrued with respect to a covered employee of a publicly held corporation¹⁷⁶ in excess of \$1 million.¹⁷⁷ A covered employee is defined by reference to SEC rules governing disclosure of executive compensation.¹⁷⁸ The Code defines a “covered employee” as

noted that “[w]hile in theory the reasonableness requirement could act as a limit on total compensation paid, this requirement has been applied primarily to prevent dividends of closely-held companies (which are not deductible) from being characterized as compensation (which is deductible).” 2006 JCT EXECUTIVE COMPENSATION REPORT, *supra* note 172, at 6.

175. Unless specifically excluded, Section 162(m) applies to all remuneration for services, including cash and the cash value of all remuneration (including benefits) paid in a medium other than cash. STAFF OF J. COMM. ON TAXATION, 107TH CONG., PRESENT LAW AND BACKGROUND RELATING TO EXECUTIVE COMPENSATION 27 (Comm. Print 2002). Compensation not subject to the deduction limit, and not taken into account in determining whether other compensation exceeds \$1 million, includes: (i) remuneration payable on a commission basis; (ii) remuneration payable solely on account of the attainment of one or more performance goals if certain independent director and shareholder approval requirements are met; (iii) payments to a tax-qualified retirement plan (including salary reduction contributions); (iv) amounts excludable from the executive’s gross income (such as employer-provided health benefits, group-term life insurance and miscellaneous fringe benefits); and (v) compensation payable under a written binding contract in effect as of February 17, 1993 (provided that such contract was not materially modified prior to the payment of the compensation). *See* I.R.C. § 162(m)(4) (West 2010). In addition, Section 162(m) does not apply to certain amounts paid by a corporation that was not a publicly held corporation and then becomes a publicly held corporation. Treas. Reg. § 1.162-27(f)(1) (as amended in 1996).

176. For these purposes, a corporation is treated as publicly held if the corporation has a class of common equity securities that is required to be registered under section 12 of the Securities Exchange Act of 1934. I.R.C. § 162(m)(2); *see also* Treas. Reg. § 1.162-27(c)(1) (providing that (i) voluntary registration of securities does not cause a corporation to be publicly held; and (ii) for purposes of Section 162(m), whether a corporation is publicly held is determined based solely on whether the corporation is subject to the reporting obligations of section 12 of the Exchange Act as of the last day of its taxable year).

177. I.R.C. § 162(m)(1). The \$1 million limitation is reduced to \$500,000 with respect to certain employees of certain employers that received TARP funds. *See* I.R.C. § 162(m)(5), as added by Emergency Economic Stabilization Act of 2008, P.L. 110-343, § 302(a), 122 Stat. 3765, 3803-06. *See supra* note 83.

178. I.R.C. § 162(m)(3). Treasury Regulation Section 1.162-27(c)(2)(ii) provides that whether an individual is a covered employee for purposes of Section 162(m) is to be determined in accordance with the executive compensation disclosure

an employee of a corporation if such person is either (i) the chief executive officer of the corporation (or an individual acting in such capacity) at the end of such year, or (ii) an employee whose total compensation for such year is required to be reported because the employee is one of the four highest compensated officers for the taxable year (other than the chief executive officer).¹⁷⁹ However, as a result of amendments to the SEC disclosure rules, effective after December 15, 2006, the Service has administratively refined such definition.¹⁸⁰

rules of the Exchange Act. In accordance with such regulation, an individual is a covered employee only if he or she is employed as of the last day of the employer's taxable year. *See* Treas. Reg. § 1.162-27(c)(2)(i). The Service has concluded that an officer who resigns his or her position as an officer and employee prior to the last day of the tax year will not be considered a covered employee for such year even if, under SEC executive compensation rules, such person is required to be listed in the corporation's proxy and continues to perform services for the corporation as an independent consultant and/or director, and receive compensation from deferred bonuses, stock options, and annual income from consulting contracts unless such person intends to resume his or her responsibilities as a corporate officer in the foreseeable future. I.R.S. Priv. Ltr. Rul. 199928014 (Apr. 13, 1999).

179. I.R.C. § 162(m)(3).

180. The SEC's rules relating to executive compensation disclosure under the Exchange Act are contained in Item 402 of Regulation S-K. 17 C.F.R. 229.402 (2010). Under the disclosure rules in effect at the time Section 162(m) was enacted, and for fiscal years ending prior to December 15, 2006, named executive officers consisted of (i) all individuals serving as a corporation's chief executive officer (or acting in a similar capacity) during the last completed fiscal year regardless of compensation level, and (ii) the corporation's four most highly compensated executive officers (other than the CEO) who were serving as executive officers at the end of the last completed fiscal year. *See, e.g.*, 17 C.F.R. § 229.402 (2005). A final rule amending the SEC executive compensation disclosure rules altered the composition of the group of executives that are covered by Item 402. *See* 17 C.F.R. § 229.402 (2010), *amended by* Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53,158 (Sept. 8, 2006). As amended, Item 402 provides that the named executive officers consist of (i) all individuals serving as the corporation's principal executive officer (or acting in a similar capacity) during the last completed fiscal year ("PEO") regardless of compensation level, (ii) all individuals serving as the corporation's principal financial officer (or acting in a similar capacity) during the last completed fiscal year ("PFO") regardless of compensation level, and (iii) the corporation's three most highly compensated executive officers other than the PEO and PFO who were serving as executive officers at the end of the last completed fiscal year. *Id.* As a result of the change in the SEC disclosure rules, the Service determined that it needed to issue guidance under Section 162(m).

In an attempt to tie executive pay to corporate performance, Congress exempted from Section 162(m) any performance-based compensation that satisfied three conditions.¹⁸¹ First, the performance goals are determined by a compensation committee comprised solely of two or more outside directors of the corporation.¹⁸² Second, the material terms of the performance-based pay, including the goals established, are disclosed to shareholders and approved by a majority of shareholders in a separate vote before the compensation is paid.¹⁸³ Third, prior to payment, the compensation committee provides written certification that the performance goals and any other material terms were satisfied.¹⁸⁴

Two things happened in reaction to Section 162(m).¹⁸⁵ First, some corporations changed their method for compensating corporate executives, and performance-based pay (i.e., stock options) became the primary form of executive compensation for many corporations.¹⁸⁶ Second, some corporations ignored Section 162(m)—continuing to pay compensation above the \$1 million limitation in spite of

See I.R.S. Notice 2007-49, 2007-1 C.B. 1429. In Notice 2007-49, the Service concluded that for purposes of Section 162(m), the term “covered employee” includes any employee of a corporation if, at the close of the taxable year, such employee is either the PEO or an individual acting in such capacity, or if such employee’s total compensation for that taxable year must be reported to shareholders under the Exchange Act as being among the three highest compensated officers other than the PEO or PFO for that taxable year. *Id.* The term “covered employee” does not include a corporation’s PFO (or an individual acting in such capacity). *Id.*

181. I.R.C. § 162(m)(4)(C); *see also* Treas. Reg. § 1.162-27(e) (as amended in 1995). According to the Staff of the Joint Committee on Taxation, “[w]hile not specifically mentioned in the legislative history, the exception to the limitation for performance-based compensation reflects the view that such compensation, by its nature, is not ‘excessive.’” 2006 JCT EXECUTIVE COMPENSATION REPORT, *supra* note 172, at 6.

182. I.R.C. § 162(m)(4)(C)(i).

183. I.R.C. § 162(m)(4)(C)(ii).

184. I.R.C. § 162(m)(4)(C)(iii).

185. *See* Conway, *supra* note 24, at 396.

186. *Id.*

the loss of a tax deduction.¹⁸⁷ Corporate shareholders bear the costs of these corporate actions.¹⁸⁸

Numerous commentators have noted that Section 162(m) has had the unintended consequence of increasing executive compensation at publicly held corporations.¹⁸⁹ Professor Kathryn Kennedy notes that, rather than discouraging excessive compensation:

The congressionally mandated \$1 million limit on executive salary became the industry standard. Suddenly all top executives and key employees expected companies to offer a base salary of one

187. *Id.*

188. *Id.* See also Mullane, *supra* note 87, at 493 (asserting that the burden of Congress' efforts to limit executive compensation through the tax code falls on "rank-and-file Americans" to a substantial extent).

189. See, e.g., Conway, *supra* note 24, at 396. Additionally, see Gary Shorter et al., *Excessive CEO Pay: Background and Policy Approaches*, CONG. RESEARCH SERV., RS22604 at 5 (Nov. 29, 2007), available at <http://opencrs.com/document/RS22604/2007-11-29/>, where the authors state:

P.L. 103-66 established code section 162 (m) . . . which imposes a \$1 million cap that applies to the CEO and the four next-highest-paid officers. No tax deduction for compensation above the \$1 million limit is permitted, except for "performance-based" pay, such as commissions or stock options, where the ultimate compensation received by the executive depends on the stock price, reported sales or profits, or some other financial indicator. The OBRA provision is widely believed to have contributed to the increased use of stock options in CEO compensation in the mid- and late 1990s. To the extent that this is true, OBRA may have had the unintended consequence of *increasing* CEO pay.

Id. (citations omitted); see also Gregg D. Polsky, *Controlling Executive Compensation Through the Tax Code*, 64 WASH. & LEE L. REV. 877, 926 (2007) ("The empirical evidence suggests that § 162(m) has had unintended consequences. Executive compensation has increased, while a large number of firms are apparently forfeiting valuable tax deductions. Both of these results are contrary to the intent of Congress."); Stabile, *supra* note 24, at 82 n.5 ("One reason for the large increase in executive compensation over the last decade is the move toward performance-based compensation, particularly stock options, which have generated huge returns over the last decade." (citations omitted)); Stephen M. Salley, Note, "Fixing" Executive Compensation: Will Congress, Shareholder Activism, or the New SEC Disclosure Rules Change the Way Business is Done in American Boardrooms?, 70 OHIO ST. L.J. 757, 763 (2009) ("Most commentators have noted that § 162(m) is a classic example of the law of unintended consequences, because the amendments, designed to reduce compensation, have actually resulted in higher pay packages as a result of bonuses and stock options.").

million dollars in addition to generous stock options and retirement benefits. The new base salary was expected regardless of industry, effect, company development, or shareholder concerns. The perception existed that boards of directors conceded to the new base salary because the compensation packages were completely deductible.¹⁹⁰

Professor Kennedy also notes that the focus on performance-based compensation resulting from Section 162(m) provides corporate executives with an incentive to focus on short-term performance.¹⁹¹ According to Professor Kennedy:

[I]nstead of focusing on long-term objectives, executives concentrated on quarterly performance. By meeting Wall Street's performance expectations, the stock price increased at a faster pace, generating more short-term profit for executives upon each stock sale. Unless the stock option program required a vesting period of several years, executives could, and did, exercise their options earlier. In addition, some boards of directors fueled the problem by awarding executives large amounts of option awards, allowing executives to sell stock, re-pricing poor performing stock options in order to prevent executives from leaving, and back dating stock options. The perception was that reliance on the use of options encouraged executives to ignore the long-term effect of current strategy in favor of their short-term financial interests, which increased the risk of dilution for non-employee shareholders.¹⁹²

A related consequence of Section 162(m) is that it provides corporate executives with an incentive to manipulate corporate performance to maximize their own personal wealth.¹⁹³ Famous securities class-action lawyer William Lerach described the system created by Section 162(m) as follows:

190. Kathryn J. Kennedy, *Excessive Executive Compensation: Prior Federal Attempts to Curb Perceived Abuses*, 10 HOUS. BUS. & TAX L.J. 196, 220 (2010) (citing John A. Byrne, *That's Some Pay Cap, Bill*, BUSINESSWEEK, Apr. 25, 1994, at 57, available at <http://www.businessweek.com/archives/1994/b336854.arc.htm>).

191. See *id.* (citing Lee E. Sheppard, *Big Paydays Are Back!*, 124 TAX NOTES 99 (2009)).

192. *Id.* at 221.

193. Martin D. Mobley, *Compensation Committee Reports Post-Sarbanes Oxley: Unimproved Disclosure of Executive Compensation Policies and Practices*, 1 COLUM. BUS. L. REV. 111, 123 (2005).

[W]hether driven by greed or envy—or perhaps both—it is clear now that an increasingly lavish—crazy—stock-option compensation system incentivized corporate executives to do whatever—and I mean whatever—had to be done to meet earnings expectations, so that they could achieve corporate earnings targets to trigger their performance bonuses and boost the stock price so that their stock options could be exercised and they could sell stock at high prices.¹⁹⁴

It is not just commentators that are critical of Section 162(m). The same government that enacted this provision in 1993 is now critical of the consequences caused by its passage. For example, Christopher Cox, the former chairman of the SEC and Congressman, stated before Congress:

[O]ne of the most significant reasons that non-salary forms of compensation have ballooned since the early 1990s is the \$1 million legislative cap on salaries for certain top public company executives that was added to the Internal Revenue Code in 1993.

As a Member of Congress at the time, I well remember that the stated purpose was to control the rate of growth in CEO pay. With complete hindsight, we can now all agree that this purpose was not achieved. Indeed, this tax law change deserves pride of place in the Museum of Unintended Consequences.¹⁹⁵

Many corporations, concluding that compliance with Section 162(m) would interfere with their business judgment, have decided that it is in their best long-term interests to pay compensation that is not deductible.¹⁹⁶ In

194. William Lerach, *Plundering America: How American Investors Got Taken for Trillions by Corporate Insiders*, 8 STAN. J.L. BUS. & FIN. 69, 96 (2002) (footnote omitted).

195. *Stock Options Backdating: Hearing Before the S. Comm. On Banking, Housing and Urban Affairs*, 109th Cong. (2006) (statement of Rep. Christopher Cox, Chairman, U.S. Sec. and Exch. Comm'n), available at <http://www.sec.gov/news/testimony/2006/ts090606cc.htm> (speaking about SEC disclosure rules regarding executive compensation). The Staff of the Joint Committee on Taxation has noted that a number of studies also support the fact that Section 162(m) has not reduced the growth in executive compensation. See 2006 JCT EXECUTIVE COMPENSATION REPORT, *supra* note 172, at 7 (citations omitted).

196. See Conway, *supra* note 24, at 405 (citing Steven Balsam & Qin Jennifer Yin, *Explaining Firm Willingness to Forfeit Tax Deductions Under Internal Revenue Code Section 162(m): The Million-Dollar Cap*, 24 J. ACCT. & PUB. POL'Y 300, 321 (2005) (finding that almost forty percent of affected corporations forfeited deductions rather than comply with the \$1 million cap)); see also

these cases, Section 162(m) acts to increase the cost of executive compensation.¹⁹⁷

The Staff of the Joint Committee on Taxation, in a review of the Enron Corporation and its related entities following the Enron bankruptcy,¹⁹⁸ concluded that “[t]he \$1

Polsky, *supra* note 189, at 926 (“The empirical evidence suggests that § 162(m) has had unintended consequences. Executive compensation has increased, while a large number of firms are apparently forfeiting valuable tax deductions. Both of these results are contrary to the intent of Congress.”). As an illustration of the ineffectiveness of Section 162(m), note the disclosure found in the 2009 Proxy Statement for Oracle Compensation:

In evaluating potential compensation alternatives, our Compensation Committee considers the possible impact of Section 162(m) of the Internal Revenue Code of 1986, as amended (the “Code”). Section 162(m) of the Code places a limit of \$1 million on the amount of compensation that we may deduct as a business expense in any year with respect to certain of our most highly paid executives unless, among other things, such compensation is performance based and has been approved by stockholders. *We therefore design our executive compensation program, including our annual performance cash bonus plan and our stock option grants, to be eligible for deductibility to the extent permitted by the relevant tax regulations, including Section 162(m) of the Code. However, we may from time to time pay compensation to our senior executives that may not be deductible if there are non-tax reasons for doing so.*

ORACLE CORP. 2009 PROXY STATEMENT 36 (2010) (emphasis added), available at <http://www.oracle.com/us/corporate/investor-relations/proxy/orcl-2010-proxy-170698.pdf>. Notwithstanding the fact that all of Oracle’s 2009 compensation qualified for a deduction under Section 162, Larry Ellison earned approximately \$130 million that year. *See supra* note 17 and accompanying text.

197. *See Conway, supra* note 24, at 405-06.

198. In February 2002, Senator Max Baucus and Senator Charles E. Grassley of the Senate Finance Committee directed the staff of the Joint Committee on Taxation to review the Enron Corporation and related entities:

The review focused on two principal areas: (1) Enron’s use of tax shelter arrangements, offshore entities, and special purpose entities, and (2) the compensation arrangements of Enron employees, including tax-qualified retirement plans, nonqualified deferred compensation arrangements, and other arrangements, in order to analyze the factors that may have contributed to the loss of benefits and the extent to which losses were experienced by different groups of employees.

STAFF OF J. COMM. ON TAXATION, 108TH CONG., REP. OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS 2 (Comm. Print 2003) [hereinafter JCT ENRON REPORT].

million deduction limitation was designed to address corporate governance concerns that top executives were receiving excessive compensation. The experience with Enron indicates that the limitation is not effective in achieving its purposes. Taxpayers may choose to pay nondeductible compensation, and accept the potential adverse tax consequences.”¹⁹⁹

The Joint Committee recommended that Section 162(m) be repealed and that laws other than the tax code be used to address excessive compensation issues.²⁰⁰

B. *Sections 280(g) and 4999*

Section 162(m) was not Congress’ first attempt at defining reasonable compensation in the public company context. Ten years earlier, in 1984, Congress attempted to limit golden parachute arrangements made by public corporations to key executives.²⁰¹ According to Congress, such arrangements were designed to dissuade interested buyers from pursuing an acquisition, drive up the cost of corporate acquisitions, or encourage corporate executives

199. *Id.* at 43. For 1998 through 2000, \$48.5 million, or eleven percent of total compensation paid by Enron to its management, was nondeductible under Section 162(m). *Id.* at 42-43.

200. *Id.* at 43.

201. One commentator describes “golden parachute agreements” as follows:

In response to increasing corporate mergers and acquisitions, target corporations have developed defensive tactics designed to discourage both tender offers and successful takeovers by aggressor corporations. One defensive tactic, increasingly popular with corporate management, is the “golden parachute” agreement. Golden parachute agreements provide for lucrative payments to key executives in the event of change in corporate ownership or control. Theoretically, the cost of these payments increases overall takeover costs and thereby discourages takeover attempts.

Dana M. Leonard, *Golden Parachutes and Draconian Measures Aimed at Control: Is Internal Revenue Code Section 280G the Proper Regulatory Mode of Shareholder Protection?*, 54 U. CIN. L. REV. 1293, 1293 (1986) (footnotes omitted).

with parachute arrangement to pursue acquisitions not in the best interests of their shareholders.²⁰²

As part of the Deficit Reduction Act of 1984, Congress enacted Sections 280G and 4999 to “discourage transactions which tended to reduce amounts which might otherwise be paid to target corporation shareholders.”²⁰³ Section 280G restricts the ability of a corporation to deduct excess parachute payments, while Section 4999 imposes an excise tax of twenty percent on recipients of such amounts.²⁰⁴

For these purposes, a “parachute payment” is any payment in the nature of compensation (including payments to be made under a covenant not to compete or similar arrangement) that meets three requirements. First, the payment is made to (or for the benefit of) a disqualified individual.²⁰⁵ Second, such payment is contingent on a

202. See STAFF OF J. COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 199-200 (Comm. Print 1984) [hereinafter 1984 JCT REPORT].

203. *Id.* at 201; see I.R.C. § 280G(a) (West 2010); I.R.C. § 4999(a) (2006); see also Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 464. Congress believed that:

In almost any takeover situation, be it hostile or friendly, the acquiring company in theory will pay a maximum amount and no more. To the extent some of that amount, directly or indirectly, must be paid to executives and other key personnel of the target corporation, because of the existence of golden parachutes or similar arrangements, there is less for the shareholders of that corporation. Congress decided to discourage transactions which tended to reduce amounts which might otherwise be paid to target corporation shareholders.

1984 JCT REPORT, *supra* note 202, at 201; see also Bruce A. Wolk, *The Golden Parachute Provisions: Time for Repeal?*, 21 VA. TAX REV. 125, 126 (2001); Jamie Dietrich Hankinson, Comment, *Golden Parachute Tax Provisions Fall Flat: Tax Gross-ups Soften Their Impact to Executives and Square D Overinflates Their Coverage*, 34 STETSON L. REV. 767, 770 (2005).

204. See I.R.C. § 280G; I.R.C. § 4999; see also 1984 JCT REPORT, *supra* note 202, at 200. The twenty percent excise tax imposed by Section 4999 is in addition to the regular income and Social Security taxes imposed on the payment. See I.R.C. §§ 4999(a), (c)(1).

205. I.R.C. § 280G(b)(2)(A). Hankinson notes that,

The phrase “golden parachute payment” has a different meaning in common business usage than in a tax context. As commonly used, the term refers to large severance payments made when an executive’s employment is terminated following a corporate acquisition. However, for federal income tax purposes, the phrase, “golden parachute

change in the ownership or effective control of a corporation, or in the ownership of a substantial portion of its assets.²⁰⁶ Third, the aggregate present value of all such payments made or to be made to the disqualified individual equals or exceeds three times the disqualified individual's base amount.²⁰⁷ In addition, a parachute payment includes "any payment in the nature of compensation to (or for the benefit of) a disqualified individual if such payment is made pursuant to any agreement that violates any generally enforced securities laws or regulations."²⁰⁸ Sections 280G and 4999 generally are limited to public corporations.²⁰⁹

A disqualified individual is any employee, independent contractor, or other person (specified in Treasury Regulations) who performs personal services for the corporation and who is an officer, shareholder, or highly compensated individual of the corporation.²¹⁰ A highly compensated individual is an individual who is (or would be if the individual were an employee) among the highest paid one percent of the employees (or, if less, among the 250 highest paid employees) of the corporation.²¹¹

payment," has a definition that is keyed to a change in corporate control and is not limited to severance or other termination payments, but instead applies to any payment of compensation.

Hankinson, *supra* note 203, at 773.

206. I.R.C. § 280G(b)(2)(A)(i). *But see* 2006 JCT EXECUTIVE COMPENSATION REPORT, *supra* note 172, at 44 (stating, incorrectly, that "[i]n some cases, the compensation agreement for a corporate executive may provide for payments to be made if the executive loses his or her job as a result of a change in control of the company. Such payments are referred to as 'golden parachute payments'").

207. I.R.C. § 280G(b)(2)(A)(ii). An individual's base amount is the average annual compensation includible in the individual's gross income over the five taxable years of such individual preceding the individual's taxable year in which the change in ownership or control occurs. If the individual did not perform services for the corporation throughout that entire five-year period, the relevant period is that portion of the five-year period in which he or she did perform services for the corporation (with compensation for any portion of a taxable year being annualized before an average is determined). I.R.C. § 280G(b)(3); 1984 JCT REPORT, *supra* note 202, at 200.

208. I.R.C. § 280G(b)(2)(B).

209. *See* I.R.C. § 280G(b)(5).

210. I.R.C. § 280G(c). Personal service corporations and similar entities are generally treated as individuals for this purpose. I.R.C. § 280G(c).

211. I.R.C. § 280G(c).

Under Section 280G, a corporation will be denied a tax deduction only for the portion of a parachute payment that qualifies as an excess parachute payment.²¹² Section 280G defines excess parachute payment as the amount by which the parachute payment exceeds the individual's base amount.²¹³ However, the portion of the payment that the corporation establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered before the change in control will reduce the amount treated as an excess parachute payment.²¹⁴ The legislative history to Sections 280G and 4999 suggests that such a reduction will only occur in rare circumstances:

The Congress believed that in most large, publicly-held corporations, top executives are not under-compensated. Accordingly, the Congress contemplated that only in rare cases, if any, will any portion of a parachute payment be treated as reasonable compensation in response to an argument that a disqualified individual with respect to such a corporation was under-compensated for periods prior to the change in ownership or control.²¹⁵

These provisions, however, have not accomplished Congress' stated goals at the time of enactment.²¹⁶ "In practice, corporations continue to make these payments,

212. I.R.C. § 280G(a).

213. I.R.C. § 280G(b)(1).

214. I.R.C. § 280G(b)(4).

215. 1984 JCT REPORT, *supra* note 202, at 204. The Conference Report gives the following examples of reasonable compensation:

- (1) payments in cancellation of a normal stock option, or normal stock appreciation right, granted more than one year before the change;
- (2) exercises after termination of stock options or stock appreciation rights issued as part of a normal compensation package granted more than one year before the change;
- (3) compensation previously earned and deferred pursuant to a plan of the employer, such as a staggered bonus plan, or at the election of the employee; and
- (4) amounts paid under a retirement plan that supplements a tax-qualified plan to the extent such amounts are designed to compensate a newly-hired key employee for the loss of retirement benefits attributable to services performed for a prior employer.

H.R. Rep. No. 99-861, at 852-53 (1984) (Conf. Rep.); *see also* 1984 JCT REPORT, *supra* note 202, at 204.

216. *See, e.g.*, Hankinson, *supra* note 203, at 770.

despite the payments being nondeductible, and executives continue to receive these payments, despite the excise tax imposed.”²¹⁷ In fact, the enactment of these two provisions led to several unintended consequences that have increased the use of golden parachute arrangements and their cost to corporate shareholders. First, according to Professor Kennedy, “[Section 280G] was viewed as tacit approval by the government of these arrangements as long as the award provided did not exceed three times base compensation. Indeed, ‘hundreds of companies that had no change-in-control agreements’ introduced these arrangements soon after section 280G was enacted.”²¹⁸

Second, some companies reduced or eliminated the cost of the excise tax imposed on corporate executives pursuant to Section 4999 through the use of gross-up payments to executives.²¹⁹ The economic effect of a gross-up provision is

217. *Id.* In addition, Professors Cherry and Wong note:

Yet another form of compensation that has proven to be controversial is the so-called golden parachute, a payment to the executive that is typically triggered in the event of a change of control in the corporation. The ostensible reason to adopt golden parachutes is to align the interest of the management with shareholders’ interests—otherwise, incumbent management might resist an acquisition for the purpose of perpetuating their own tenure. However, in the vivid words of one commentator, golden parachutes conjure the “image of a laughing executive landing softly with oodles of misappropriated corporate assets while his corporation goes down in flames.”

Cherry & Wong, *supra* note 80, at 374 (citations omitted).

218. Kennedy, *supra* note 190, at 204 (citing Michael C. Jensen & Kevin J. Murphy, *Remuneration: Where We’ve Been, How We Got Here, What are the Problems, and How to Fix Them* 28 (ECGI Finance Working Paper Series in Finance No. 44/2004, 2004), available at <http://ssrn.com/abstract=561305>; see also Conway, *supra* note 24, at 414-19; Richard P. Bress, Note, *Golden Parachutes: Untangling the Ripcords*, 39 STAN. L. REV. 955, 963 n.38 (1987); Miske, *supra* note 87, at 1680.

219. See, e.g., Conway, *supra* note 24, at 417 (“The enactment of [sections] 280G and 4999 resulted in executives often requiring that the company pay the excise tax to the IRS on behalf of the executive if they are to be paid a golden parachute payment.”); Wolk, *supra* note 203, at 139-40. See also Corporate Counsel’s Guide to Employment Contracts, which sets forth the purpose of a gross-up provision as follows:

The purpose of a tax gross-up allowance is to provide an executive with sufficient additional benefits to pay the parachute tax on the benefits to which he or she is entitled without the gross-up and the parachute and income taxes on the gross-up benefits so that his or her net after-tax

to transfer the punitive effects of the Section 4999 excise tax from the executive receiving the golden parachute payment to the corporation's shareholders.²²⁰

Commentators generally observe that the golden parachute rules have done little to affect the amount of

position is equal to the position the executive would have been in had there been no parachute penalty tax.

CORP. COUNS. GD. TO EMPL. CONTRACTS § 14:45 (2007).

220. See Hankinson, *supra* note 203, at 770-71. See also Stabile, *supra* note 24, noting that:

There is evidence that not only have many corporations foregone the deduction, but a number have also added a "gross up" to the compensation paid to executives to take account of the tax imposed by section 280G; that is, they increase the payment made by an amount equal to the taxes that the executive will be required to pay. Thus, instead of eliminating or minimizing golden parachutes, the effect of the tax imposed by section 280G is to make such payments more expensive to the corporations.

Id. at 93 (citing *Tate & Lyle PLC v. Staley Continental, Inc.*, CIV. A. No. 9813, 1988 WL 46064 (Del. Ch. May 9, 1988)). In *Tate & Lyle*, the court discussed the effects of the gross-up provisions of a company's golden parachute arrangement as follows:

In an effort to assure the full benefits of the golden and tin parachutes to its employees, Staley adopted a plan of excise tax "gross-ups", which could cost Staley, at least, \$13.8 million. These gross-ups require Staley to compensate each beneficiary of a parachute for the 20% federal excise tax mandated by 26 U.S.C. §§ 280G, 4999. In effect, the gross-ups insure that each beneficiary receives the full amount of the parachute without any offset due to the excise tax.

Tate & Lyle PLC, 1988 WL 46064, at *3. See also Corporate Counsel's Guide to Employment Contracts, which notes that "the sole beneficiary of the tax gross-up is the U.S. Treasury," and concludes that:

The cost of either type of tax gross-up allowance is very substantial to the corporation in relation to the benefits provided to the executive. Based on a 31 percent income tax rate, it costs a corporation, after taxes (using a 34 percent corporate tax rate), approximately 75 percent of an individual's average annual compensation to provide the individual with pretax benefits equal to 299 percent, and post-tax benefits equal to 207 percent, of the individual's average annual compensation to provide an individual with pretax benefits equal to 415 percent and post-tax benefits equal to 224 percent of the individual's average annual compensation. Therefore, the corporate after-tax cost doubles in order to provide the individual, after tax, with an additional 17 percent of average annual compensation.

CORP. COUNS. GD. TO EMPL. CONTRACTS, *supra* note 219, § 14:45.

compensation payable upon a change of control. Rather, the rules are often thought of as providing a road map as to how to structure compensation arrangements. The government best summarized the effects of Sections 280G and 4999 when it stated “[i]t is not uncommon for employment agreements to provide that, in the event the employee is subject to the excise tax, the tax will be paid by the company, with a gross up to reflect the income tax payable as a result of the employer’s payment of the tax.”²²¹

221. *Written Testimony of the Staff of the Joint Committee on Taxation on Executive Compensation and Company-Owned Life Insurance Arrangements of Enron Corporation and Related Entities Before the S. Comm. of Fin.*, 110th Cong. 31 n.44 (2003) (statement of Mary M. Schmitt, Acting Chief of Staff of the Joint Comm. on Taxation). For a discussion on how shareholders bear the burden of these anti-golden parachute provisions, see Conway, *supra* note 24, concluding that:

In summary, because parachute payments are often still part of executive compensation contracts, whatever the reasons, corporations are now losing deductions for any excess compensation paid plus the extra twenty percent excise taxes often paid on behalf the executives. As such, the anti-golden parachute provisions do not make the corporate compensation structure better for shareholders; rather, they make the whole prospect more expensive for the shareholders. While the executives remain in the same favorable position, the corporations have to forfeit the deductions, resulting in less profit for the shareholders. In addition, the shareholders still face the possibility that the corporation is too expensive to purchase. These results are inconsistent with the intent behind the provisions, mainly to help protect shareholder interests.

Id. at 419.

See also Hankinson, *supra* note 203, where the author states:

Ironically, Congress’s concern that shareholders were receiving less money for their shares in mergers as a result of golden parachute payments has been exacerbated by §§ 280G and 4999 and tax gross-ups. Eliminating §§ 280G and 4999 would actually decrease the cost of mergers and increase the money paid to the target shareholders or acquirer’s shareholders over time. However, if Congress intends to legislate corporate conduct through § 280G, then, at a minimum, § 4999 should be repealed. Section 4999 is not effective in deterring executives from accepting golden parachute payments when the corporation pays the additional tax for the executive. When the corporation also grosses up for the executive’s individual income tax on these payments, the total cost to the corporation increases.

Id. at 802 (footnote omitted).

IV. ARGUING AGAINST EXTENDING A REASONABLENESS
STANDARD TO THE PUBLIC CORPORATION

More than a dozen years ago, Professor Stabile observed that Congress' attempts to limit executive compensation—both through the general reasonableness limitation on executive compensation and specific Code provisions such as Sections 162(m), 280G, and 4999—were not “operating to affect executive compensation in a significant way.”²²² In fact, there is evidence that Congress' attempts to limit executive compensation have had the effect of increasing pay and imposing additional costs on the corporations and shareholders that Congress might be expected to protect.²²³

Professor Stabile then asks “whether the Code can and should serve as a more aggressive constraint.”²²⁴ She offers two distinct potential congressional goals for limiting executive compensation through the Code: revenue raising and a social goal of regulating executive pay.²²⁵ Her conclusion is that “the Code has no role in policing executive compensation.”²²⁶ With respect to the first rationale, Professor Stabile notes that “[w]hile raising revenue is a legitimate use of the Code, raising tax revenues does not appear to be Congress' goal in enacting the provisions that currently limit the executive compensation deduction.”²²⁷ With respect to government's goal of regulating executive pay, Stabile argues that such decision should remain with the corporation rather than the government—provided that the shareholders “are aware of what executives are being paid and have the ability to express displeasure if they do not like the decisions being made by the board”²²⁸

222. Stabile, *supra* note 24, at 94.

223. See *supra* text accompanying notes 185-200, 216-21.

224. Stabile, *supra* note 24, at 94.

225. *Id.* at 94-100.

226. *Id.* at 101.

227. *Id.*; see also STAFF OF J. COMM. ON TAXATION, 103D CONG., ESTIMATED BUDGET EFFECTS OF THE REVENUE PROVISIONS OF H.R. 2641, at 1 (Comm. Print 1993) (estimating that Section 162(m) would increase revenue by only \$42 million in 1994, and by \$335 million over a five year period); 1984 JCT REPORT, *supra* note 202, at 207 (estimating that Sections 280G and 4999 would increase fiscal year budget receipts by less than \$5 million per year).

228. See Stabile, *supra* note 24, at 101.

Today, the question of the government's role in regulating executive pay remains fertile ground for debate. While some ask "why bother,"²²⁹ many commentators continue to believe that the government has a role in policing executive pay.²³⁰ Regulating executive pay through additional corporate disclosure²³¹ or the judiciary²³² is beyond the scope of this Article. This author believes, however, that it would be inappropriate to continue to attempt to control the level of executive compensation through the tax code.

Despite the numerous commentators who have analyzed this issue and determined that the Code has been ineffective in controlling the pay of executives of public corporations, one commentator continues to argue that Section 162(a)(1) should be enforced against public corporations in addition to private corporations.²³³ Aaron Zelinsky's arguments echo those expressed by his father, Professor Edward Zelinsky, almost a generation ago²³⁴—arguments that the elder Zelinsky has since abandoned.²³⁵

229. See, e.g., Markham, *supra* note 66, at 336-47.

230. See, e.g., Charles M. Elson, Essay, *The Answer to Excessive Executive Compensation Is Risk, Not the Market*, 2 J. BUS. & TECH. L. 403 (2007) (arguing for both increased director independence and greater equity ownership of both directors and executives in companies that they manage); Matthew Farrell, Note, *A Role for the Judiciary in Reforming Executive Compensation: The Implications of Securities and Exchange Commission v. Bank of America Corp.*, 96 CORNELL L. REV. 169 (2010) (arguing for a more active role for the judiciary); Zelinsky, *supra* note 13 (arguing for increased scrutiny by the Service under Section 162(a)(1)).

231. *But see* Elson, *supra* note 230, at 404 (noting that corporate disclosure will not solve the problem of excessive executive compensation).

232. See, e.g., Farrell, *supra* note 230.

233. See Zelinsky, *supra* note 13, at 644.

234. See Zelinsky, *supra* note 38.

235. See Edward A. Zelinsky, *Eberl's, Independent Investors, and the Incoherence of the Reasonable Compensation Rule*, 92 TAX NOTES 555, 559 (2001) ("Under all of the circumstances, the best alternative is to abolish the reasonable compensation rule by repealing it legislatively."). See also Edward A. Zelinsky, *Is Martha Stewart Reasonably Compensated?*, 99 TAX NOTES 919 (2003), where Professor Zelinsky states:

I once believed that the tax system could and would scrutinize the reasonability of compensation granted by publicly traded corporations to their managers. I believe this no more. . . .

Professor Zelinsky argued, in 1993, that the overpayment of executive compensation inflates a corporation's tax deductions, which, in turn, reduces the corporate tax base.²³⁶ Since corporate executives have the ability to set their own salaries, the argument continues, they in effect constitute an unofficial class of shareholders, and the excessive compensation they receive is essentially equivalent to nondeductible dividends.²³⁷ By allowing the deduction of such dividends, the Service has allowed public corporations to understate their taxable income.²³⁸

Professor Zelinsky's argument would have been more convincing if he had not then stated that "[w]hether the Treasury loses revenue from this erosion of the corporate tax base is unclear and, ultimately, irrelevant."²³⁹ It is puzzling that one could argue against the erosion of the corporate tax base if it is not known whether particular actions have the effect of reducing the amount of tax collected. If, rather, Professor Zelinsky's argument was one in favor of "assuring the accuracy of the tax base" regardless of the amount of tax collected, the argument appears to be more logical.²⁴⁰ Although this argument targets the right issue, Professor Zelinsky attacks the wrong actors. It is

The long-term solution is a legislative fix to the statute that abolishes the anomaly that is today the reasonable compensation doctrine.

Id. at 923.

236. *See Zelinsky, supra* note 38, at 1123 ("Addressing that question, I conclude that denying deductibility to excessive managerial compensation will, in the aggregate, enhance the accuracy with which the code measures the corporate income tax base: excessive payments to corporate executives are disguised dividends, corporate earnings diverted from shareholders via managers' control of their own terms of employment.").

237. *See id.*

238. *See id.* ("As a matter of tax policy, disallowing deductibility to exorbitant levels of executive remuneration is an administrable extension of the code's current rule that, to preserve the corporate tax base against disguised dividends, closely held corporations can only deduct reasonable levels of compensation.").

239. *Id.* at 1125.

240. This appears to be the argument made by Professor Zelinsky. *See id.* ("Such considerations however, ought not to be controlling when the goal is assuring the accuracy of the tax base as a goal distinct from (and frequently incompatible with) maximizing the public fisc.").

agreed that the Service should be concerned about the accuracy of the tax base in situations where shareholders are overinflating costs and experiencing no economic loss. But, where the overinflated costs are being paid to the managers of the corporation, there is a true cost to the shareholders. Even if one were to agree that executive compensation were not set by an arm's length process, such amount would have to be categorized in one of three ways: (i) corporate waste,²⁴¹ (ii) rents extracted by the management,²⁴² or (iii) theft.²⁴³ All three of these items are generally deductible in computing corporate income.²⁴⁴ The removal of a tax deduction for these amounts would result in an overstatement of the corporate tax base, while allowing a deduction would preserve an accurate computation of such tax base.

The failure to allow a deduction in the case of excessive compensation would result in corporate shareholders bearing the burden of these costs twice: (i) when such waste, managerial rent or theft is actually incurred through the compensatory payment; and (ii) when the Service requires

241. One argument that Section 162(a)(1) was intended to limit the scope of the business expense deduction is that the original revenue regulations promulgated under the predecessor to Section 162(a)(1) disallowed a deduction for a salary that constituted "waste or appropriation of assets of the corporation." Zelinsky, *supra* note 13, at 639 (quoting Moran, *supra* note 97, at III.B.4). This reference to waste or appropriation of corporate assets was excluded from subsequent regulations. Moran, *supra* note 95, at A-12. In addition, this portion of the regulations has never been cited in case law. See Zelinsky, *supra* note 13, at 639. According to one commentator, "[t]his may suggest that any amount of compensation paid by a publicly held corporation should be per se reasonable." Moran, *supra* note 95, at A-12. While it is unclear that the last statement necessarily follows from the exclusion of the waste or appropriation language of the regulations, there is no authority that would prevent a corporation from deducting amounts found to have been spent unwisely.

242. Professors Bebchuk and Fried use the term "rents" to describe benefits received by corporate management greater than those that could have been obtained through an arm's-length bargaining process. See BEBCHUCK & FRIED, *supra* note 38, at 4-5. Regardless of the manner obtained, there is no authority that any such rents would be nondeductible when paid by a corporation.

243. Treas. Reg. § 1.165-8(a)(1) (1960) ("Except as otherwise provided . . . any loss arising from theft is allowable as a deduction under section 165(a) for the taxable year in which the loss is sustained.").

244. See *supra* notes 241-43.

the corporation to pay tax on profits that it never realized. Professor Zelinsky's argument that corporate management is an unofficial class of shareholders, and that payments to such class should be treated in the same manner as dividends, misses the point.²⁴⁵ The unofficial stock ownership of which Professor Zelinsky complains is very different than the actual stock ownership of those who have invested in the corporation and, regardless of the meritorious nature of the compensation received, one should not punish the stockholders for the actions of this separate class.

Aaron Zelinsky provides little guidance as to his motive for expanding the scope of Section 162(a)(1), stating only that Section 162(a)(1) "is best understood as an attempt to preserve the corporate tax base from erosion" ²⁴⁶ However, no authority is cited for how much erosion is caused to the corporate tax base by allowing a deduction for all compensation paid by public corporations.²⁴⁷ If Zelinsky is taking the approach of his father—that the accuracy of the tax base is the more important goal²⁴⁸—such position suffers from the same weaknesses as his father's arguments in that it ignores the reality of the corporate structure, and penalizes the actual shareholders of the corporation in an attempt to preserve the accuracy of the tax base even where no showing of inaccuracy exists.

However, the largest problem with Zelinsky's argument in favor of expanding the scope of Section 162(a)(1) is that it would usurp the power of corporate boards of directors in setting compensation with an amorphous standard of reasonableness. Unlike Section 162(m), which provides a bright-line standard of \$1 million of executive pay, or Sections 280G and 4999, which take effect only after parachute payments in excess of three times an executive's compensation are made, Section 162(a)(1) provides a

245. See *supra* text accompanying note 237.

246. Zelinsky, *supra* note 13, at 641.

247. As stated previously, Professor Edward Zelinsky noted that "whether the Treasury loses revenue from this erosion of the corporate tax base is unclear . . ." Zelinsky, *supra* note 38, at 1125; see also *supra* text accompanying note 239.

248. See Zelinsky, *supra* note 38, at 1125; see also *supra* note 240 and accompanying text.

corporate board no guidance as to the level of deductible pay.²⁴⁹ Corporations and the Service would be looking in the rearview mirror—fighting over compensation paid years earlier—to determine whether an amount paid would be considered reasonable.²⁵⁰

Even Zelinsky's father, who once supported an expansion of Section 162(a)(1) to public corporations prior to abandoning such position, did not believe that such a vague standard was workable.²⁵¹ In fact, Professor Zelinsky argued for the passage of the bright-line, objective test of reasonableness found in Section 162(m) to analyze the deductibility of corporate compensation.²⁵²

This usurpation of power would occur even without any clear guidance as to how reasonableness would be determined. Aaron Zelinsky provides two possible alternatives.²⁵³ First, the Service could examine the compensation paid by publicly held corporations in an identical fashion to the manner that Section 162(a)(1) is

249. See *supra* Part III.A-B.

250. See Sikon, *supra* note 148, at 326. Sikon notes:

[T]he large corporation is on notice through the provisions of Internal Revenue Code sections 280G and 162(m) as to how to determine the potentially non-deductible amounts. Except for the reduction to excess parachute payments for reasonable compensation, these provisions do not require a highly subjective judgment of value by the government. They are straight-forward mathematical calculations.

Id.

251. See Zelinsky, *supra* note 38, at 1125.

252. See *id.* at 1125-26. For a discussion of the objective test, see Sikon, *supra* note 148, which states:

It is only for public policy reasons that these statutory provisions arose, seemingly to curb abuses in corporate activity that were perceived by the legislature to have a detrimental effect on the shareholders of the companies, as well as on the general public. In the spirit of section 162(a), these provisions provide bright line calculations of presumptively unreasonable compensation and render it non-deductible.

Id. at 325-26 (footnotes omitted).

253. See Zelinsky, *supra* note 13, at 645-46. Regardless of the interference of the Service in corporate governance, Zelinsky concludes that "given the reality of managerial power and the resulting degradation of the corporate tax base through unreasonable compensation payments to the executives of publicly held businesses, one of these solutions is appropriate." *Id.* at 646.

applied to privately held corporations.²⁵⁴ While Zelinsky argues that this alternative would provide “clear guidance to public boards,”²⁵⁵ he also notes:

However, such an analysis might not address the systemic problems which result from managerial power over board decisions in the public corporate context. If unreasonable compensation and board capture are widespread phenomena, the use of comparables could actually hurt, rather than help, preserve the corporate tax base, as salaries could be increased in tandem by opportunistic executives.²⁵⁶

This first approach, then, adds nothing to the conversation regarding the reasonableness of executive pay. As Zelinsky admits, if unreasonable compensation is a widespread problem, use of comparables to determine the reasonableness of a particular corporation’s pay structure would be ineffective and lead to excessive compensation becoming the norm.²⁵⁷ If unreasonable compensation is not a widespread problem, then Zelinsky’s concern about applying a reasonableness standard to public company pay becomes a moot issue.

Zelinsky’s second proposed approach, which takes into account the managerial power theory of executive compensation, would require the Service to first analyze whether there was an arm’s-length relationship between a corporation’s management and its board of directors when the compensation was determined.²⁵⁸ According to Zelinsky, “[g]reater board independence would indicate a stronger presumption that compensation is reasonable.”²⁵⁹

While this approach provides an opportunity to ruminate about the methodology for determining the nature

254. *See id.* at 645.

255. *Id.* at 645.

256. *Id.* at 646.

257. *See id.*

258. *See id.*

259. *Id.* Zelinsky notes that this approach would “have the potentially negative impact of inserting the Service into corporate governance.” *Id.* Regardless, however, Zelinsky concludes that “given the reality of managerial power and the resulting degradation of the corporate tax base through unreasonable compensation payments to the executives of publicly held businesses, one of these solutions is appropriate.” *Id.*

of the corporate director-management relationship, such a generalized standard provides no roadmap for fixing the problems with executive pay.²⁶⁰ How would the Service determine whether there was an arm's-length relationship between the corporation's management and its board of directors? What factors would the Service use to determine whether managerial power affected the board's decision to set executive pay? Until objective standards can be defined, it is unclear that anything would be accomplished other than confusion.

The difficulty in determining reasonableness in the public company context, and this author's concern with Zelinsky's suggestions, arose with the beginning words of his article. Zelinsky notes that in March 2009, AIG provoked a firestorm by releasing information about bonuses to be paid that were "derided as most outrageous and unreasonable."²⁶¹ Zelinsky expresses agreement with these statements when he states that "taxpayer subsidization of unreasonable compensation is hardly limited to AIG."²⁶² Nowhere in his article, however, does Zelinsky cite any proof that such compensation is truly unreasonable (rather than large in absolute amount), that such compensation was not determined through an arm's-length process of negotiation, or that AIG's board of directors suffers from the problems of managerial power which troubled Professors Bebchuk and Fried.²⁶³ An expansion of the reasonableness test of Section 162(a)(1)

260. The opportunity to ruminate about the relationship between corporate directors and corporate managers is not new. Zelinsky distinguishes his article from his father's, noting that he has "incorporate[d] recent developments in the managerial power hypothesis into interpretations of § 162(a)(1), and by proposing a modification of the IRS and the Court's decisionmaking processes to incorporate the managerial power hypothesis." *Id.* at 640 n.13. However, in 1993, Professor Zelinsky's rationale for applying Section 162(a)(1) to public corporations rested, in part, on "[t]he contemporary critique of executive pay practices [which] holds that, in the case of publicly held businesses, essentially undisciplined executives also set their own remuneration at excess levels." Zelinsky, *supra* note 38, at 1124; *see also supra* text accompanying notes 49-51.

261. Zelinsky, *supra* note 13, at 637 (citing Edmund L. Andrews & Peter Baker, *Bonus Money at Troubled A.I.G. Draws Heavy Criticism*, N.Y. TIMES, Mar. 15, 2009, <http://www.nytimes.com/2009/03/16/business/16aig.html>) (internal quotation marks omitted).

262. *Id.*

263. *See* BEBCHUK & FRIED, *supra* note 38, at 4-6.

would provide the government with the subjective power to scrutinize corporate actions on compensation any time that the public, the press or the Congress “feels” that executive pay is too much.

Zelinsky argues that there will be three side effects to his proposal.²⁶⁴ First, limiting deductions for the portion of executive compensation deemed excessive would stop “taxpayer subsidies of economically inefficient behavior.”²⁶⁵ Second, applying a reasonableness standard “to publicly traded corporations would harmonize the tax treatment of public and private corporations with respect to excessive executive compensation.”²⁶⁶ Finally, the Service’s litigation and success in the courts on this issue would potentially “reduce excessive compensation through shaming and potential derivative suits.”²⁶⁷

Zelinsky, however, presents no evidence that any of these benefits would result. Except for a potential harmonization between publicly traded and privately held corporations, experience suggests that corporations would continue to pay compensation at the desired levels—

264. See Zelinsky, *supra* note 13, at 644.

265. *Id.*

266. *Id.* at 645.

267. *Id.* Zelinsky further states:

Corporations, and the individuals who sit on their boards, may seek to avoid the negative publicity associated with government suits alleging excessive compensation for income tax purposes. If so, they will be less likely to pay excessive salaries. . . . Moreover, the threat of future derivative action will provide a further check on excessive compensation. Once the IRS and the courts have made a determination that particular compensation is excessive under § 162, shareholders could potentially use that determination to substantiate derivative suits for recovery against the board for corporate waste.

This Comment does not advocate IRS oversight as the lead mechanism for purifying the muddled world of executive compensation: addressing the issues raised by the managerial power hypothesis will likely require coordinated action by a variety of governmental and nongovernmental actors. Nevertheless, if the IRS focuses on ensuring that the corporate tax base is protected against deduction of unreasonable compensation paid by publicly traded corporations, shareholders and shareholder activists are likely to be emboldened by the IRS’s enforcement activities.

Id.

foregoing a tax deduction where the Service successfully challenged its pay levels.²⁶⁸ Rather than having the effect of reducing executive compensation, the more likely result of the Service's challenge to executive compensation would be inurement to the benefit of the Treasury at the expense of a corporation's shareholders. In addition, there is no indication that public shaming or concern regarding derivative lawsuits would have any effect on the largess of executive pay. One need only look to Sections 162(m) and 280G, which serve as proxies for determining whether executive compensation is reasonable. There is no evidence that either of these provisions have caused corporate boards to reduce the size of executive pay packages. Instead, as previously discussed, corporations continue to increase the amount paid to executives in spite of the fact that these Code provisions place upon such pay the stamp of unreasonableness.

In another recently published piece, a remarkably insightful comment regarding the ability of the government to use the tax code to affect executive compensation was made:

In the end, the ingenuity of accountants and lawyers will always be able to find creative solutions to congressional attempts to limit executive compensation, particularly via the tax code. In contrast to legal scholarship, research from the business and economics academy indicates that executive pay is the result of a competitive market. Taken at face value, this research strongly suggests that manipulations of the tax code, effectively government caps on pay, will cause market distortions. If the law attempts to dictate compensation at a level below market compensation, the overwhelming power of the market will find a way around this problem.²⁶⁹

Such has been the result with Section 162(m) and Sections 280G and 4999. One can only hope that Congress will heed these words before enacting future tax legislation regarding executive compensation.

268. See *supra* Part III.A-B. See also *supra* note 66, where Professor Yablon notes that the "economic inefficiency" that concerns Zelinsky may be simply the cost of doing business through widely-held public corporations.

269. Salley, *supra* note 189, at 763 (footnote omitted).

CONCLUSION

Section 162(a)(1) provides a deduction for a reasonable allowance for compensation for services actually rendered. The literal language of the statute, combined with past practice and an analysis of the legislative history, makes it clear that such provision was meant to expand the business expense deduction of Section 162(a) rather than to limit such deduction.

The problem of excessive executive compensation may be real or, as much of the research has shown, no problem may exist. Regardless of which side of this controversy one believes, one thing is clear: Congress' attempts to legislate executive compensation through the Code have had the unintended consequences of contributing to an increase in executive pay. While Congress may again in the future attempt to deal with the public outrage surrounding this issue, one can only hope that it has learned from its experience that our tax laws are not the proper mechanism for regulating executive pay.