# Executive Pay Practices Under Scrutiny:

## Companies' skirting of a tax rule meant to spur performance-based pay contributed to the options scandal. Penalties may follow a Senate hearing

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The Senate Finance Committee will turn its attention on Sept. 6 to a little-known provision in the U.S. tax code that critics say has been widely exploited by public companies eager to take tax deductions on their top executives' sometimes lavish compensation.

Known as Section 162(m) of the Internal Revenue Code, that provision limits the tax deductibility of pay for the five highest-paid executives at public companies to $1 million, unless the pay is determined to be "performance-based." To qualify as performance-based pay, compensation committees must set "pre-established" and "objective" performance goals. Shareholders must approve the goals, and the compensation committee must certify they were met.

The rule, enacted in 1993 by former President Clinton, was intended to tie top executives' soaring pay packages more closely to a company's performance by limiting tax deductions. Until that time, executive compensation had been entirely deductible. But corporate governance experts, academics, and some members of Congress contend that many big companies have figured out how to bypass the rule by setting easy-to-reach goals that make the lion's share of executive pay—from bonuses to stock grants—"performance-based" so they can write those payments off on tax returns.

BILLIONS IN LOST TAXES. The net effect, say critics, is that many companies now deduct almost all of their top executives' compensation. Violations of Section 162(m) are now playing a substantial role in the evolving scandal over backdated options. Says former SEC Chairman Harvey Pitt: "What [162(m)] did was create incentives to find other forms of compensation so people could get over the $1 million threshold without running afoul of the code."

The end run around Section 162(m) may have cost the federal government billions of dollars in lost taxes since the rule was enacted 13 years ago. Harvard Law School Professor Lucien Bebchuk estimates that forgone taxes as a result of widespread abuse of 162(m) has cost the U.S. Treasury at least $20 billion. "The numbers are gigantic," he says.

To bypass the $1 million cap on tax deductions in Section 162(m), known as the $1 million rule, some companies have taken advantage of the tax law's requirement for "objective" goals. In proxy statements, they often include a smorgasbord of potential metrics to qualify pay as performance-based, including nonfinancial metrics such as customer satisfaction, customer service, and diversity.

PILOT PROJECT. Although companies must disclose those metrics to shareholders, neither the IRS nor the SEC require the targets for the metrics to be disclosed. The upshot: Shareholders

may have approved a litany of metrics, but they are rarely informed of the specific results. "Targets can be set so low that everybody with a knowledge of the business knows that it is essentially guaranteed," says Harvard's Bebchuk.

The opaqueness of corporate compliance with Section 162(m) is now coming under greater scrutiny by the Internal Revenue Service. The IRS says a pilot project dubbed the "Corporate Executive Compliance" initiative found "sufficient problems" with Section 162(m)—and six other tax-related executive compensation issues—in 24 audits conducted in 2004 and 2005 to warrant making the program permanent this year.

The IRS declined to name the companies in its audits or its findings. But federal tax auditors are stepping up scrutiny of executive compensation plans and could seek to reclaim millions in back taxes, say compensation consultants. "You're definitely going to see people being caught for not complying," says Brian Cumberland, managing director, compensation and benefits, at consulting firm Alvarez & Marsal Tax Advisory Services. "The rules are complicated, and companies were not focused on it."

REFORM MOVEMENT. Corporate governance advocates and lawmakers also appear poised to step in with reform proposals. Patrick McGurn, special counsel at shareholder advisory firm Institutional Shareholder Services, says 75% of respondents in an April survey want his firm to challenge Section 162(m) programs "if the metrics are not rigorous enough." Concern also is brewing on Capitol Hill that top executives have taken advantage of loopholes in Section 162(m) to benefit themselves. "Outside the corporate suite, Americans don't get to pick and choose how much of their employer-provided income is taxed," said Senate Finance Committee Chairman Charles Grassley (R-Iowa) in a statement last week. "Their employers report their salaries to the IRS, and that's that." His committee plans to call IRS Commissioner Mark Everson, along with SEC, corporate governance, and accounting experts, to testify on Sept. 6.

Just how vague are some performance-based metrics? ISS's McGurn says telecom giant BellSouth (BLS) is typical. In its 2006 proxy statement, the Atlanta-based company says it can choose from a host of benchmarks to qualify its top executives' pay as performance-based, including revenue, net income, capital expenditures, customer service, and overall performance compared to industry peers. And, according to the proxy, it can assess its executives based on "individual achievement of personal commitments." The proxy statement does not define that metric nor its targets to qualify pay as performance-based. IRS officials declined to comment on whether "individual achievement of personal commitments" meets Section 162(m) standards. BellSouth declined to provide more detail.

"Sadly, this is par for the course," says McGurn. "It's the sort of vague gobbledygook that we get under this statute." In a statement, BellSouth spokesman Jeff Battcher says, "BellSouth provides disclosure regarding executive compensation plans as required by the SEC in its public fillings. BellSouth considers individual employee compensation matters, which are not required to be disclosed by the SEC, to be confidential."

STOCK OPTION "BENEFITS." Indeed, Section 162(m) played a big part in the evolving scandal over backdated options, say critics. That's because the rule automatically defines stock options as performance-based as long they are not issued at a price below a stock's current market value and the grant is approved by shareholders. As a result, companies loaded stock options into executive compensation packages, in part to ensure a tax deduction.

Under accounting rules, companies can deduct stock options from taxes once that option is cashed in. The tax deduction is equal to the difference between the option's value on the date it was issued and its exercise price. "They are huge deductions," says Steve Balsam, a professor of accounting at Temple University who will testify before the Senate Finance Committee. In fact, under Section 162(m) rules, stock options provide a double perk. Prior to new accounting rules enacted last year, the options also didn't have to be recorded as an expense. "Under 162(m), even though they didn't record an accounting expense, there is no requirement that they record (one) to take a tax deduction," says Balsam.

With more than 100 companies now under investigation for backdating options, Senate Finance Committee members plan to probe how tax laws such as 162(m), designed to curb exorbitant executive pay, may in fact have fostered more chicanery. Says an aide to the Senate Finance Committee: "We're going to be looking very hard at 162(m). This law has done nothing to control executive compensation. Now the question is what are we going to do with this thing." The IRS's Large and Medium-Sized Business unit said on July 28 that it is examining as many as 40 companies for possible tax-code violations, including Section 162(m), related to backdated stock options.

BACK TAXES LIKELY. Some critics say the "performance-based" loophole in Section 162(m) should never have been written into the law. By capping tax deductions at $1 million unless pay is performance-based, many companies boosted executive pay packages to qualify for write-offs. "162(m) as a way to reduce compensation levels is a failure," says Charles Elson, director of the Weinberg Center for Corporate Governance at the University of Delaware.

"They will call everything under the sun performance-based." Regardless, says former SEC chief Pitt, even if companies haven't violated the letter of the law by using vague metrics and easy targets, many of them have violated its spirit. "The fact that Congress passed a stupid law doesn't give anyone the right to violate it," he says.

Intensified scrutiny of Section 162(m) compliance could mean legal trouble for a host of companies. Compensation consultant Cumberland says his clients are asking for a copy of a questionnaire on executive compensation plans sent out by IRS auditors. The reason: Companies are expecting the IRS to try to collect back taxes based on violations of Section 162(m)—and, he says, some of those audits are likely to be successful. "The IRS previously wasn't focused on this," says Cumberland. "So companies weren't trying to comply."